Confidence must be earned

Amundi ASSET MANAGEMENT

December 2018

Global Investment **Views**

Pascal BLANQUÉ
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Strategies for tough markets

This year has proven to be challenging for portfolio construction, as well as regarding returns. To put this into perspective, for 2009-17, our analysis shows that each year, on average, 76% of major asset classes (including different regional government bonds, equity, inflation-linked, currency and commodities) recorded positive performances. In 2018, the story has changed: we are heading towards an unprecedented year in which less than 20% of asset classes have been in positive territory*. Markets have started to price in a slowdown in global growth and tighter liquidity conditions, in a more complex than expected political environment (trade tariffs and populism). Vulnerabilities in the more stretched areas of the market (growth stocks in equities and credit markets) and idiosyncratic stories (Argentina, Turkey, Italy) are the main consequences of this new narrative.

Moving into 2019, Central Bank policy will be crucial again with regard to determining market sentiment. Given a potential slowdown in growth and weak financial conditions, a Fed shying away from further tightening would give new oxygen to the markets. Also, the ECB will likely be increasingly uncomfortable with raising rates in such a scenario. In the meantime, the risk of policy mistakes will remain high: How far can Trump trade policy go? What could the implications for input prices and corporate margins be? Can China growth hold on? These are all elements that could fuel volatility, but also lead to an opening up of opportunities in the market.

We think that, at least in the first part of 2019, **there will be room to increase risk-taking in some areas of the market**, given the more appealing valuations and the fact that most of the bond yield repricing is behind us. Signs of more dovish Fed could represent an additional positive trigger. **We believe that a constructive earnings outlook will support a recovery in equities, based on a theme rotation.** We continue to recommend a selective approach, with a focus on **quality and valuations** (and dividends later in the year) across the board, with the US equity market currently remaining our key call. Moving ahead, we would seek **entry points** to benefit from this year's price dislocations. One area of focus is **Europe**, once the political risk linked to next year's parliamentary elections in May, fades away. **Emerging markets** could be another area of interest, as the threat from rising interest rates and a strong dollar should dissipate with early signs of a slowdown in the US. Against a backdrop of economic and political uncertainty, we would continue to focus on drawdown management, as capital preservation will be at the top of the list of investor concerns. This means focusing on bottom-up research to select stocks and bonds with stronger fundamentals that could be more resilient to market downturns and to avoid concentration in the most risky areas of the market, where **sustainability of returns** could be under threat (ie, over-indebted companies, overvalued stocks).

High conviction ideas

- **Multi-asset:** We remain cautious on risk assets and think investors should add regional equity diversification to support portfolio resilience to political risk and uncertainty on policy actions. A strategy is to play the rotation of themes in Europe, favouring EMU value vs the broad market. We also have become more constructive on Japan, as the market remains cheap, with light positioning and resilience, despite the unexceptional earnings season. On DM credit, we maintain a reduced risk exposure in Europe.
- **Fixed income:** A slowing of growth momentum reduces the pressure on Central Banks to accelerate monetary normalisation. In this environment, the case for being short duration is receding, and we now have a neutral view in the US (more on government guarantee/mortgages securities than on US Treasuries). On credit, we stick to a conservative view, with a focus on less indebted companies due to the spillover effects from tighter liquidity conditions. In Europe, for tactical reasons and due to expected issuance in the financial sector, we have become even more cautious in the short term, but we remain more constructive in the medium term.
- **Equities:** Q3 earnings season confirms a positive outlook for the US, but, so far, a more mixed result for European and Japanese equity. A rotation towards more defensive themes is confirmed, as is a correction of growth vs value. In the US, we are very cautious on high-growth/high-momentum stocks. In Europe, we focus on those companies regarding which we believe valuations have overshot to the downside and are effectively pricing in substantial/excessive earnings per share weakness.
- **Real assets**: In a world of low interest rates, investors will continue to look for portfolio diversification and yield enhancement. In our view, selectively allocating to real assets can help to capture liquidity premiums in the market, as well as to potentially enhance income returns and protect against inflation, given the recurrent cash flow associated with some investments, such as infrastructure and real estate. These two areas (with natural resources) are expected to show the strongest asset growth in the next five years.

*Analysis run on 30 indices for different asset classes with data as of November 20, 2018.
ECB= European Central Bank, EM = Emerging Markets, DM = Developed Markets.

MACRO & STATEGY

Philippe ITHURBIDE
Global Head of Research

Monica DEFEND
Head of Strategy, Deputy Head of Research

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Head of Macroeconomic Research

Slowing growth, political uncertainties dominate

G20: a temporary but meaningful easing of trade tensions between the US and China. After the G20 talks, Presidents Trump agreed with Xi Jinping to temporary pause the increase in tariffs rates. With midterm elections over, Trump could find an opportunity to deepen the negotiations. However, any appeasement would be likely short lived. The opposition between the two nations will return to the forefront in 2019, as their strategic interests tend to diverge (high technology, intellectual property rights) and because the opposition to China is supported by a large part of the American electorate (the campaign for the 2020 presidential elections will start in 2019).

The US cycle: economic slowdown in sight. Towards a pause in the Fed's tightening in 2019. The recent rise in credit spreads, if it continues, will tighten the financing conditions for heavily indebted companies. It will therefore be taken seriously by the Fed, also considering that fiscal multipliers will gradually fade in the course of next year. Recent rhetoric of FOMC members has been on the dovish side. The Fed's communication aims to pave the way for a change in its 'dots', signalling a stop in monetary tightening sooner than expected next year. This is in line with our expectations and it is consistent with the three rate hikes we expect (one in December and two in H1 2019). It does however clearly tell us that the risk is that the Fed will do less.

Europe: fog thickens with political uncertainty. No thinning before spring? In the EU, growth has slowed, but is expected to remain above potential. Monetary conditions are still accommodative and oil prices have dropped recently. The only caveat is that politics prevails over economics. **In the UK**, we expect a favorable vote in parliament on the withdrawal agreement negotiated by Theresa May. Even if it fails to be adopted on 10 December, this plan can still be amended (at the margin) and be the subject of a second vote at the beginning of 2019. The majority of Tory Eurosceptic Members of Parliament, being moderate, would probably vote positively to avoid a "hard Brexit" at the end of March. Under these conditions, the UK would benefit from a long transition period during which trade rules would be unchanged. With less uncertainty, UK growth should be able to regain some of the ground lost since mid-2016. **In Italy**, tensions with the EU Commission will remain alive, probably until the European elections in May 2019. However, general elections cannot be ruled out by then. The League has continued to gain ground in polls at the expense of M5S. Such an evolution, if confirmed, would open the door, after new elections, to a coalition League / Forza Italia (which would likely abandon some stimulus measures). Italian growth slowed sharply in Q3 and bank credit conditions have begun to tighten. It will be necessary to monitor closely whether rising bond yields are tightening bank credit conditions to the point of deteriorating the economic outlook. Risks to growth are skewed to the downside.

The Strategist's View – Euro credit re-pricing

European credit repriced wider, together with weaker equity markets and political uncertainties. **Valuations are much better now,** while positioning lightened further, as market players further cut their exposure. The primary market saw initial encouraging signs of improving activity from European names and financials, but these failed to act as a tailwind for secondary markets and currently prevailing de-risking finally reduced liquidity and activity. The results of the 2018 **stress test** on EU banks were credit-friendly, as they showed a solid outcome for the EU banking industry, with strongly improved capital and asset quality positions with respect to the previous test, held two years ago. Among non-financial issuers, the earnings season confirmed that credit metrics remain overall sound, as financial leverage remain at low historical levels. **S&P's decision** to revise its outlook but not its rating on Italy represented a partial positive surprise. In this situation, short maturities outperformed medium to long-term maturities after the S&P decision, confirming that the search for yield is still a focus in this segment. However, the following persisting confrontation between the government and the EU commission kept pressure and volatility on periphery issuers. In conclusion, and despite a still cautious investors' sentiment on risky assets, **the mix of stronger valuations, still sound credit metrics and lighter market exposure looks overall encouraging for European credit, looking forward.** Political developments and more clues from ECB in terms of next year reinvestments are likely to represent the major drivers in the short-term. In a late cycle phase, the focus will continue to be on security selection, avoiding over-indebted securities, and on monitoring market liquidity.

“*Political risks will keep market volatility high.*”

FOMC=Federal Open Market Committee.

MULTI-ASSET

Play regional diversification in a risk cautious setting

Investors have so far dealt with tight valuations and meagre returns in 2018. So what are the main themes asset allocators should consider for the coming months? Firstly, the **late cycle narrative** remains in place, with its features of slower growth, a modest rise in inflation, and a peak in earnings growth. Secondly, heightened **geopolitical and idiosyncratic risks** continue to weigh on sentiment. We therefore confirm our view for **low absolute exposure on risk assets.** However, we still think we are in the "**last race**" for risky assets, hence the idea of playing tactical opportunities or investing in mispriced assets, like Japanese equities or EMU Value stocks. On the other hand, we believe investors should reduce exposure to expensive assets, especially the areas of the credit market where spreads do not compensate for market risk and reduced liquidity. The deteriorating liquidity outlook, combined with the low expected returns are among the challenges for investors: focusing on effective portfolio diversification and effective liquidity management will be key.

High conviction ideas

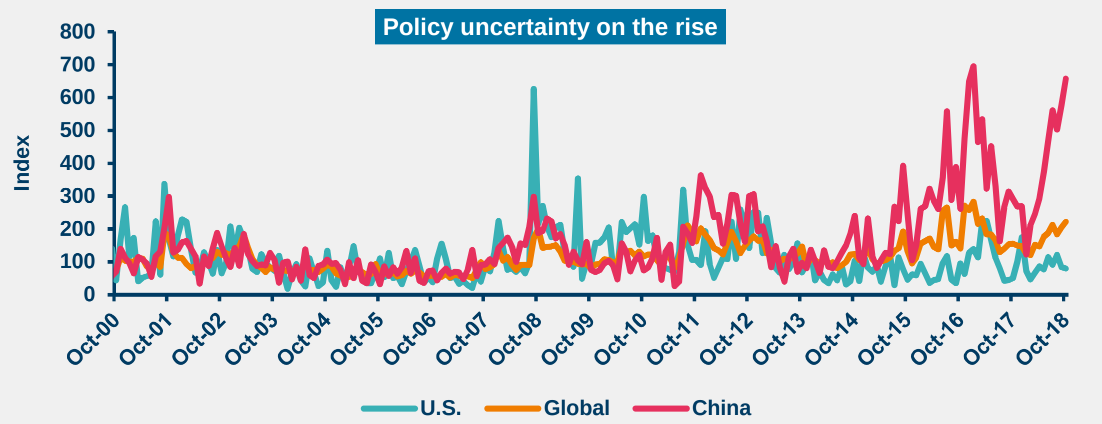
The current high level of uncertainty calls for a cautious stance on risk assets. On equities, we keep a marginally positive/close to neutral overall view, trying to diversify the regional allocation, with a strong focus on value. In particular, we prefer areas that are less exposed to current geopolitical risks: eg, Japan, which has been resilient despite the mediocre earnings season, has limited exposure to the US-China trade disputes or to the European political crisis. This factor, combined with cheap valuations and light positioning makes the NIKKEI appealing in our view. In US equities we maintain a positive tilt as they appear attractive, based on macro fundamentals (growth outlook, earnings and buybacks). In Europe we have now a preference for the EMU Value index as a defensive stance, supported by valuation aspects and technical factors.

In EM markets, we favour China vs Global EM, as we think that the proactive stance of Chinese policymakers through different channels should be sufficient to avoid derailing growth, especially considering the risks coming from tariff threats.

In fixed income sovereign markets, we believe investors should maintain a modest under-weight exposure on the German curve (where yields could bottom out, and move higher) whilst we are more positive on US Treasuries (which could benefit from their perceived safe haven status in volatile periods). Strategies that benefit from inflation surprises (ie, inflation linked bonds) are also recommended in the current late cycle phase to deal with potential inflation surprises. With Brexit confusion remaining high, UK rates remain vulnerable to corrections: however, we would note that conditions are still supportive for a cautious position on UK 10Y real rate. On credit, we have a neutral view, having gradually trimmed our preference in the past months, due to tight valuations and increased geopolitical risks, as well as less favourable liquidity conditions.

Risks and hedging

We continue to suggest exposure to gold, both as a hedge against rising geopolitical tensions and to take advantage of a possible softer stance from the Fed. In case of volatility spikes, the yen would tend to outperform the US dollar. We also suggest implementing options strategies to protect against spread widening in high yield.



Source: Amundi, Bloomberg. Data as of 20 November 2018.

Matteo GERMANO
Head of Multi-Asset

> ***Geopolitical themes unfolding in tighter liquidity conditions, call for defensive risk asset allocation.***

FIXED INCOME

Eric BRARD
Head of Fixed Income

Yerlan SYZDYKOV
Head of Emerging Markets

Kenneth J. TAUBES
CIO of US Investment Management

"Increase duration and reduce credit risk, as markets adjust for tighter liquidity conditions."

Credit is bearing the burden of tightening liquidity

Overall assessment

This year has been challenging for bond investors, as they've had to deal with rising rates in the US, idiosyncratic stories (EM, Italy), and repricing of credit markets. A critical factor for next year's outlook will be monetary policy orientation: if, as we believe, the Fed pauses, amid a risk of economic deceleration due to implications related to trade issues, conditions for active bond investors could improve. They will have more levers than this year to benefit from price dislocations (wider EM and credit, depressed EM FX). On rates, some upside pressure remains in the short term, as the US labour market is very tight. But, the weaker momentum in global growth, which will ultimately occur in the US as well, the late cycle narrative, and the elevated market uncertainty will tend to exert downside pressure on rates. In this environment, we recommend staying closer to neutrality on duration, especially in the US. In credit, the view is cautious: this asset class is suffering from higher rates and tighter liquidity conditions. Selection is key, as is an increased focus on debt dynamics, to avoid overleveraged situations. EM could return to being attractive sources of carry, with a dovish Fed, but investors should be ready for volatility and focus on appropriate investment horizons.

DM government bonds

The case for being too defensive in core bonds is receding, as real rates repriced higher in the US and the tightening path is fully discounted, and in Europe the ECB will find it increasingly difficult to raise rates in a slowing environment; we suggest keeping duration positions close to neutrality. We believe investors should try to add value from the movements of the curves and from relative positioning. On the curves, we prefer flattening positions in EU and steepening positions in the US. We continue to like inflation trades in the US. In EU, with a neutral view on peripheral bonds, we are cautious on Italy, but we expect that wider spreads will open up new opportunities in 2019.

Credit

Fundamentals and valuations are favourable for the Euro credit but the expected future issuance in the financial sector would suggest a tactical underweight. In the US, the expensive valuations suggest a cautious stance. Selection and focus on quality remain crucial. In particular in IG space long dated US industrials (Energy and Telecom) may offer selective opportunities. We are cautious on the high yield sectors, which are more exposed to idiosyncratic risks and overall look expensive.

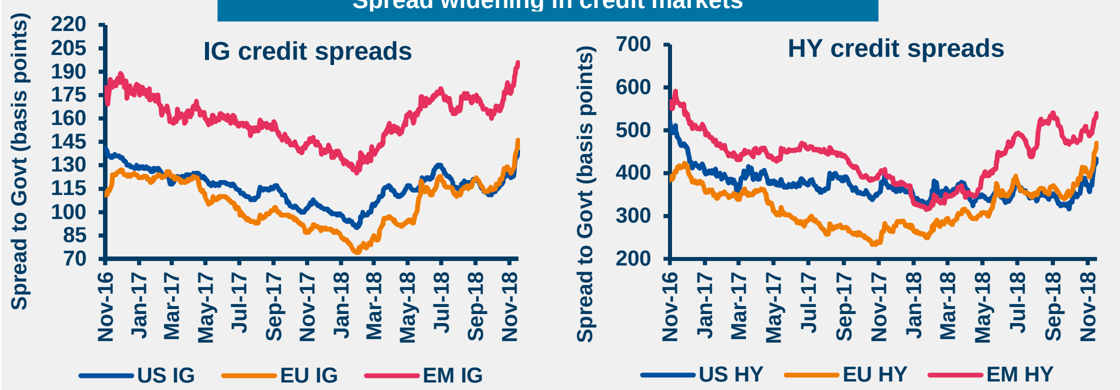
EM bonds

The short-term outlook remains tough. Risk appetite is low amid a deceleration of global growth and a slowdown in China. These factors justify a reduction of risk regarding the asset class (ie, in Mexico, which enjoyed a rally post the NAFTA agreement), while seeking selective value stories in some oversold countries and sectors. With less rationale for US rate increases and most of the USD strengthening behind us, we expect EM bonds to regain appeal over the course of 2019. Local debt has suffered from the strong USD, with inflows likely to slow, so, we remain cautious. Corporate debt has been resilient so far and we continue to prefer it to sovereign.

FX

We are still positive on the USD, given persisting CB divergences. We are neutral on GBP, as volatility is very high.

Spread widening in credit markets



Source: Amundi, Bloomberg, ICE BofA Merrill Lynch Bond Indices. Data as of 20 November 2018.

EQUITY

Strong rotation of themes

Overall assessment

The recent correction confirmed a rotation of themes in equities, from growth to value and towards more defensive stocks. We believe that this trend will continue, in markets that should remain supported by decent earnings growth, but with higher volatility as the cycle advances.

Europe

For the first time in a decade, value has outperformed in a market correction. The earnings season confirms positive earnings growth, but negative surprises, with the market penalising most companies that missed expectations instead of rewarding the ones that beat expectations. Results show that the increase in input costs, trade war/tariffs and FX dynamics were among the top three factors negatively impacting company results among the Stoxx600. These will continue to be elements to monitor regarding stock selection. We believe that investors should focus on those companies where valuations have overshot to the downside and are pricing in substantial/excessive earnings per share (EPS) weakness.

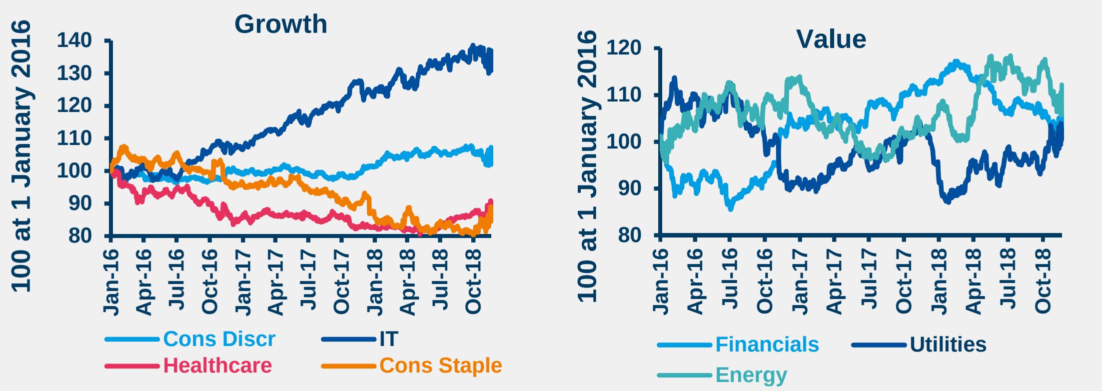
United States

The US equity market corrected in October, with a rotation of themes against high growth/high momentum stocks. In the short term, some price adjustments could still happen as a consequence of the slight deceleration of industrial activity. However, we believe that the positive trend has not been compromised. In the past, bear markets have been driven by recessions (except in 1987), and the indicators for an early recession are still missing. The earnings season has been very strong in Q3. With 90% of S&P 500 firms having reported, results were characterized by strong EPS growth (+27%) and revenue growth (+12%). EPS growth was not solely attributable to tax reform; pretax earnings grew by 14% year on year through the first three quarters of 2018. For next year, we expect a normalisation of earnings growth, and believe the market will carefully assess the sustainability of results. Margins will be under increasing pressure from tariffs, higher interest rates, a potentially flat yield curve, and rising input costs, including wage inflation. A key issue to watch will be infrastructure spending and regulation on health care/drugs post the midterm election results. These factors call for a strong focus on selection. At the sector level, we find value in capital goods, housing repair & remodel-levered stocks, financials, and telecom.

Emerging markets

Sentiment continues to be weak. We don't see major macro imbalances, but weak economic (and earnings) momentum and uncertainty regarding the depth of the Chinese slowdown are impacting the asset class. Market valuations are cheap, and a rebound through year-end looks possible, in case of a broader relief equity rally. But, in order to see a structural recovery of EM, we need a stabilisation of the USD, easing of trade disputes, and for the risk of a hard landing in China to be averted. The results of the US midterm election (less fiscal boost) and no further deterioration in trade are potential positives to watch for next year. On themes, we are now more cautious on oil, which is under pressure, due to supply/demand imbalances. We favour Brazil and Mexico, but these need to be watched regarding execution of reforms (Brazil) or market friendly policies (Mexico). We have a positive view on Russia.

MSCI World Growth and Value sectors



Source: Amundi Research, Bloomberg. As of 22 November 2018. Rebased to 100 on 1 January 2016.

Markets are pricing a too negative scenario for growth and earnings.

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Amundi
ASSET MANAGEMENT

REAL ASSETS

Pedro-Antonio ARIAS
Global Head of Real & Alternative Assets

"Real assets market projections show strong asset growth in the next five years."

The case for (selectively) allocating to real assets

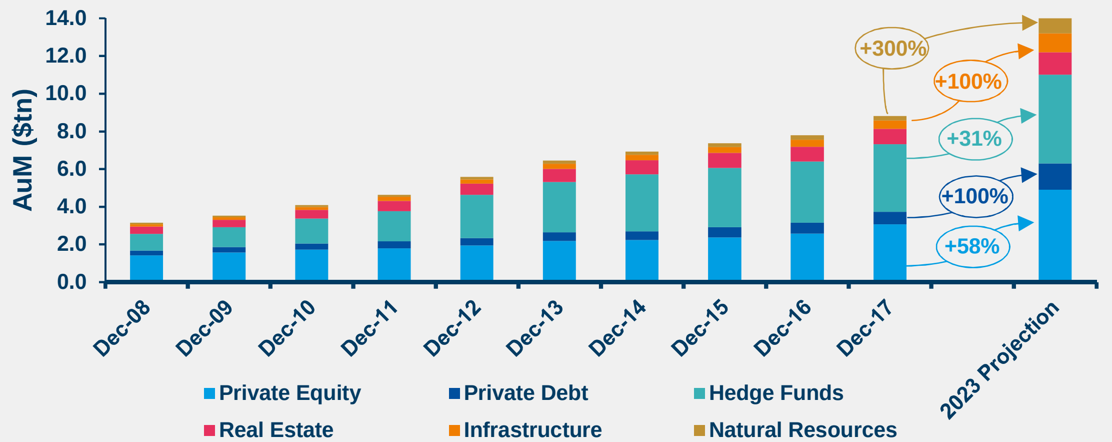
Appeal for long-term sources of diversification

The drivers for real assets in 2019 are set to remain broadly unchanged from this year. In a low yield environment, especially in Europe where the ECB remains broadly accommodative, investors are structurally more inclined to invest in alternative asset classes that, thanks to their ability to capture illiquidity premia, can potentially deliver higher income and returns while diversifying risks. As a result, fundraising in private markets and real assets, which have just recovered to their pre-crisis levels, could even accelerate.

On fixed income, investors still have a positive view on **private debt** and credit continuum solutions (which combine liquid and illiquid instruments), given the benefits they may provide to portfolios both in terms of diversification (out of the most crowded areas of the traditional credit market) and potential yield enhancement. Therefore, we are expecting an acceleration in demand for this asset class over the next year. Beyond market conditions, prudential regulation in the financial sector could also continue to boost demand for alternative sources of financing to complement banks' intermediation in financing the real economy.

Real assets investments, in particular **infrastructure** and **real estate**, potentially act as a structural hedge against inflation, an important feature for investors since the risk of higher inflation remains on the radar. On infrastructure investing, we believe that the current outlook will be sustained due to the focus by policymakers on further supporting the recovery beyond this cyclical phase. The current economic outlook in Europe could also favour real estate due to the demand for space and the expected increases in rent (expected to be the main driver of performance), as anticipated in France, Spain, Germany and Benelux. In our view, active management strategies in real estate will be critical to dealing with current high valuations and trying to protect against the future risk of rising interest rates. On **private equity**, the outlook is more challenging. A complex macro environment requires investors to be even more selective in terms of geographic areas and appropriate target companies. We think Europe still offers a positive economic backdrop and we expect private equity to remain in demand in this geographic area. However, it will be vital to identify those factors that make a company well equipped to create value for investors over the long term. Among them, we highlight the following: the quality of the management team and its involvement in the capital structure; having solid fundamentals and a history of profitability; the ability to gain a competitive advantage by having consistent organic growth and a strong desire to seek external growth through internationalisation; and a flexible approach and the agility to adapt rapidly to changing environment conditions. We would note, however, that private equity remains one of the best performing asset classes over the long run. For investors with a sufficient time horizon (8-10 years), we think that private equity remains a valuable source of returns and illiquidity premium. Based on all market and structural conditions considered above, we believe that in the long run, real assets will likely continue to be in strong demand. Recent Preqin's projections estimate that alternative assets under management will hit $14.0 trillion by 2023, up by 59% from $8.8 trillion as of the end of 2017. Among the rising trends in alternative investing, there is also the higher focus on ESG considerations as a key element to identifying best business practices.

Assets under management by asset class



Source: Preqin, Amundi. As of 20 of November 2018.

Amundi high conviction positions

Asset allocation: multi-class outlook

	1 month change	---	--	-	0	+	++	+++
Equities vs govies	→				■			
Equities vs credit	→				■			
Credit vs govies	↘				■			
Duration	↗			■				
Oil	→					■		
Gold	→					■		
Euro cash	→				■			
USD cash	→				■			

The table above represents cross asset assessment on a 3-6 month horizon, based on views expressed at the most recent global investment committee. The outlook, changes in outlook and opinions on the asset class assessment reflect the expected direction (+/-) and the strength of the conviction (+/++/+++). This assessment is subject to change.

Relative outlook and convictions by major asset class

	Asset class	1 month change on view	Underweight	Neutral	Overweight
GOVIES	US	→		●	
	Euro core	→	●		
	Euro peripherals	→		●	
	UK	→	●		
	Japan	→	●		
CREDIT	US IG	→		●	
	Euro IG	↘	●		
	US HY	↘	●		
	Euro HY	↘			●
	GEM debt hard curr	→		●	
	GEM debt loc curr	→		●	
EQUITIES	US	→			●
	Eurozone	→		●	
	UK	→		●	
	Japan	↗			●
	Pac ex Japan	→		●	
	Global EM	→		●	

CURRENCY AND REAL ASSETS

FOREX	EUR vs USD	→
	EUR vs GBP	→
	EUR vs JPY	→
	USD vs JPY	→
REAL ASSETS	Real estate	→
	Global infrastructure	→
	Private debt	→

LEGEND

↘ Downgrade
→ Unchanged
↗ Upgrade

● Underweight
● Neutral
● Overweight

Source: Amundi, as of 20 November 2018. The 3-6 month return outlook refers to research views based on expected returns by asset class. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research, investment advice or a recommendation regarding any fund or any security in particular. This information is strictly for illustrative and educational purposes and is subject to change. **This information does not represent the actual current, past or future asset allocation or portfolio of any Amundi product.**

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Important Information