Confidence must be earned

Amundi ASSET MANAGEMENT

September 2018

10 years after Lehman: A reality check for the future

CIO INSIGHTS

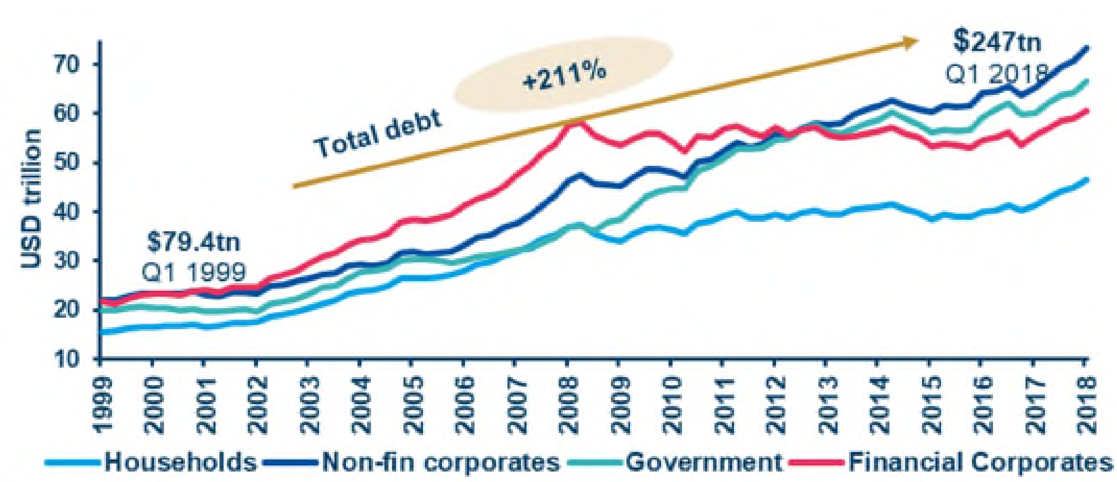
Pascal BLANQUÉ
Group Chief Investment Officer

Vincent MORTIER
Deputy Group Chief Investment Officer

It has been 10 years since the collapse of Lehman marked the beginning of the Great Recession, which threw the global economy into its deepest economic crisis since the 1930s. This is the time for assessments. In our view, the legacy of the crisis appears as ***four paradoxes, with short- and long-term consequences for the global economy and financial markets.***

1. The missed deleveraging. Despite this having been one of the longest cycles on record, we continue to have the uncomfortable sense that over time, we have continued to see largely intact imbalances: a combination of classic secular stagnation features (persistent low growth, low investment) and a super debt cycle. Even with the pace of debt accumulation having slowed, deleveraging in absolute terms has hardly happened.

Global debt by sector



Source: Amundi elaboration on IIF data, as at 31 August 2018.

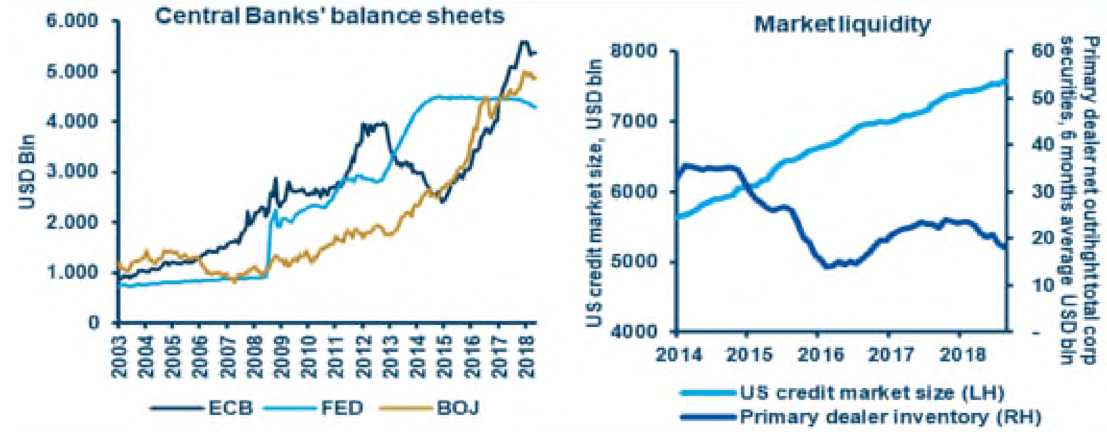
"Debt sustainability has returned with a vengeance, as prospects for higher rates re-raise the question of whether this can be absorbed without disruption."

It follows that the issue of **debt sustainability** has returned with a vengeance, as prospects for higher rates re-raise the question of whether this can be absorbed without disruption. Moreover, at a time when the **cyclical synchronised upswing is retreating globally**, with the US economy moving closer to the exhaustion of fiscal steroids, investors should realise that the classic dynamics of stronger growth leading to higher inflation and rates are not the war to fight. Rather, they should be focusing on the framework of a post-deflationary world slowing down cyclically, where disruptive forces have dissipated somewhat, though they are still haunting the landscape: low productivity growth, depressed investment. Two symmetrical temptations coexist: the belief in an artificial extension of the cycle (at a falling marginal rate of success) thanks to continuous adoption of stimulative policies or the belief, as in religion, in the narrative of higher productivity ahead and investment looming just around the corner. Both are, in our view, either end of a toxic barbell for investors. We are now living in a regime during which debt is matched by artificially low interest rates and vulnerability is high, as the tide that lifted all boats (extraordinary monetary stimulus) is close to ebbing. **Assessing these areas of vulnerabilities, which could translate into idiosyncratic risks, will be key to preventing permanent capital impairment.**

"Endogenous market risks (ie, liquidity, structure of holders) should be more of a concern for investors than classical risks (inflation leading to higher rates)".

2. The two sides of liquidity. Despite macro excesses of liquidity at balance sheet levels of central banks, we are facing micro deterioration of market liquidity, with **distortions to the structures of holders** (for example, in the high-yield space, we have seen a shift from institutional to retail money). This is a consequence of post-crisis regulation and the resulting retreat of banks from market-making operations. Regulators have focused on banks (liquidity, solvency) and client protection. Banks are perhaps less risky, but it can be argued that risks have just been shifted elsewhere: namely, to the buy side of the equation. This has also brought about **moral hazard** in various segments of the market feeding into higher exposure based on the belief that there will always be a buyer of last resort (CBs) to come to the rescue when tensions come into play. Again, **the classic risks** (let us say the mechanics of growth translating into higher inflation and rates) **are not the ones that should be of primary concern to investors in this phase**: endogenous risks - related to the market structure, where investors are poorly equipped, risk premium shifts are hard to read - are really the key unknowns. For investors, there is much more to unearth in these territories than in the crowded avenues and the **challenge for asset managers is to implement strategies to deal with this liquidity paradox.**

Two sides of liquidity



Source: Amundi elaboration on Bloomberg data, as at 31 August 2018. For right chart, Source: Amundi analysis on Bloomberg data. Primary Dealer Positions Net Outright Total Corporate Securities from the Federal Reserve Bank of New York. The US market size is estimated as the sum of the $ IG (C0A0) and HY (H0A0) cash indices face value from BofA Merrill Lynch.

"Two different scenarios are possible: lower expected returns ahead or a boost of returns, thanks to innovation. We tend to see the conservative scenario as more likely to play out".

3. A medicine with uncertain collateral effects. The macroeconomic policy response to the crisis was massive (cyclical) stimulation of growth mainly via monetary policy which was then followed by fiscal changes, even in the Euro zone. The **nature of the crisis** - a combination of Fisherian[1] debt deflationary forces and dynamics typical of balance sheet recessions[2] - significantly **limited the effectiveness of the treatment and the collateral effects are still uncertain**. This is what we learnt in the post-crisis period: (1) the impact of the crisis has gone on much longer than initially expected; (2) the great credit retreat, following a striking credit bubble, was subtracting an important component of artificially debt-inflated growth rates; and (3) the regime we have been living in has been deflationary in nature. Here, classic inflation cannot find its way in the system (patrimonial capitalism based on inherited fortunes/wealth, instead of entrepreneurship and investments, does not produce inflation easily), but rather **imbalances have taken the form of asset price inflation**, an (un)intended consequence of the crisis and of the actions taken to address it.

Two different outcomes are possible: a return to very long-term trends of lower growth (and potential for growth) and lower inflation, low equilibrium rates for higher equilibrium value of so-called risky assets; or a move to a new phase of innovation-fed productive investment, blurred

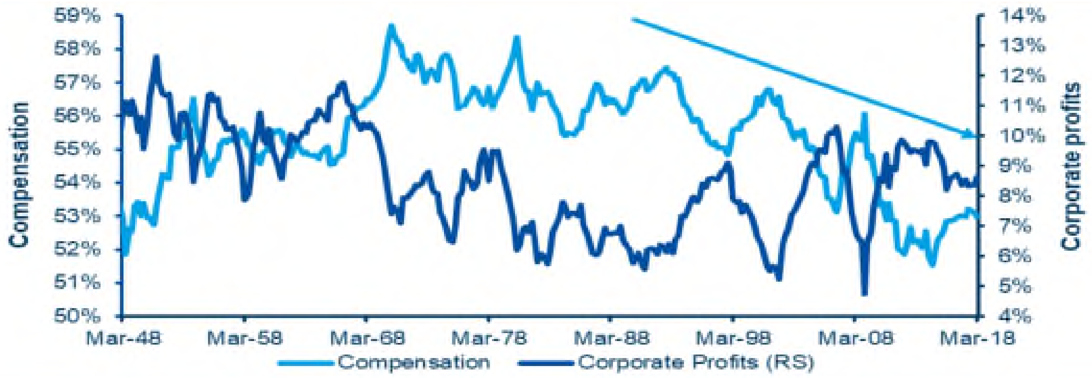
[1] The term refers to the Irving Fisher's theory of economic crisis, "The Debt-Deflation Theory of the Great Depressions", 1933.

[2] The term is attributed to the economist Richard Koo, and it refers to a recession in which high levels of private debt force economic actors to focus on saving/debt reduction rather than spending and investment.

by time lags and miscalculations. For investors, the outcome that prevails makes all the difference: in the first case, markets will tend to re-adjust their fundamentals (for example, equity market return to long-term earnings growth) and investors see lower expected returns; in the second case, we could see further upside for equities, thanks to structurally higher earnings growth. **We tend to see the first conservative scenario as the more likely outcome.**

4. Inequalities and instability have increased, not decreased. The social and political legacies of the financial crisis have been massive. Very high unemployment (especially for younger generations and under-skilled workers) has taken a long time to be absorbed and areas of weakness remain. Despite the buoyant labour market in the US and the strong job creation in Europe, wage inflation has failed to emerge. With the recovery involving the financial sphere rather than the real economy (asset inflation replacing goods and wage inflation, falling share of compensation on gross domestic income vs higher share of corporate profits), **the implications of the crisis from a social perspective have been negative**.

US compensation and profits as % of gross domestic income



Source: Bureau of Economic Analysis, as at 3 September 2018. Corporate profits with inventory valuation and capital consumption adjustments, domestic industries. Compensation of employees paid.

"Investors should assess powerful shifts in the structure of global growth towards more "domestic" engines. This calls for active global approaches".

The failure of the prevailing political systems to offer inclusive growth and the widening of inequalities have prepared the ground for the recent rise in support for populist parties and new political agendas. This can be a challenge for investors: the unpredictability of politics, little progress in political integration or in dealing with secular challenges (such as immigration, particularly in the Eurozone), the change of the equilibrium of power, with the rise of China as a global player, add **further uncertainty and volatility to financial markets**. The rise of protectionist tendencies we have seen in recent months is another consequence of this new political attitude, which is more inward-looking, with the traditional concept of globalisation now under question. The theme is not over, and investors must assess powerful shifts in the structure of global growth towards more "domestic" engines. Since investors have been "long" global trade and unconsciously correlated to the factor of global trade in their international diversification, there is a lot to do in the new framework. In this respect, **active global approaches** are crucial to identifying new trends/country-specific dynamics and being able to access opportunities that may emerge in this new environment.

What conclusions can investors take post crisis?

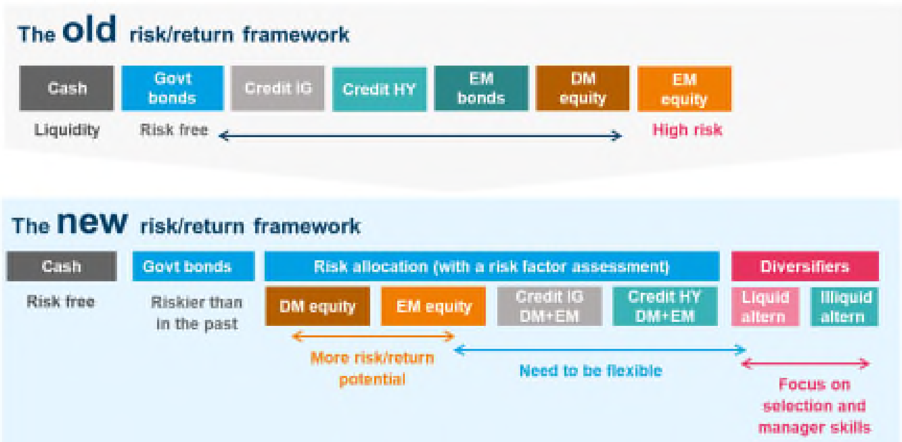
This post-crisis environment generates short- and longer-term consequences.

From a portfolio construction perspective, we currently see three main areas of development, as not all the lessons from the crisis have yet translated into real solutions.

First, consider a **wider concept of risk**. The notion of risk, dramatically limited to (short term) historical volatility, has to be enlarged based on multiple guidelines: to **liquidity**: all asset classes are supposed to be liquid at any moment but are not, and liquidity evaporates when it is most needed; to **long-term metrics for long-term investment,** such as risk of not reaching investors goals / not matching liabilities / permanent impairment of capital; and **to manage uncertainty**, for example, through multiple scenarios. Progress has been made by acknowledging the fact that cap-weighted indices are not risk-neutral and that ESG should be viewed as a pool of risk factors and integrated into the risk-based approach at the total portfolio level. But, areas for development remain.

Second, taking into consideration the new emerging risk profiles of the asset classes and rethinking their roles in asset allocation. Prior to the crisis, government bonds were, for example, generally considered to be acceptably priced for safety. Post the crisis, we learnt that the concept of a safe asset is different from a liquid asset. The financial crisis, and specifically the Euro zone debt crisis, changed the way investors would consider government bonds in asset allocation. The distinction between not risky (govies) and risky assets has significantly weakened. The hierarchy of risk premia has become fallible and fragile, and investors discovered during the crisis that **government bonds could be more risky than previously thought**, with implications for strategic allocation. With yields at historically low levels, after 30 year of bull market, the return contribution of bond allocation to a balanced portfolio has declined significantly, and this calls for **enlarging of the investment universe to get higher returns** (for example, exploiting opportunities in the full credit spectrum).

Rethink portfolio construction around a new risk framework



Source: Amundi, for illustrative purpose only.

Third, enhancing diversification. Traditional asset class diversification failed when most needed because of the correlation to some factors and portfolio risk increased. Including liquid alternatives or real assets (traditionally less correlated to the market beta) could help to enhance portfolio diversification and return potential by capturing idiosyncratic alpha based on a manager's skills or the liquidity premium.

"It's is not time to be too defensive, but to play rotation of themes (quality/ value in equity), increase the focus on "Western core", and exploit market dislocation (EM) as an entry point".

With a shorter-term perspective, the economic slowdown we expect to see ahead will likely unveil sets of risks well beyond the classic ones (stronger growth, higher inflation leading to higher rates), such cracks in the most imbalanced situations, political risk (tariffs/uncertainties in the US policy action, Brazil elections) on the macro side, and liquidity and positioning on the market side. **Risk-off sentiment may emerge, triggered by idiosyncratic situations** (Turkey and Italy as the most recent examples) reviving the appeal of the "Western core". **Core assets and core rates should receive some support while we should see rotation of styles towards quality and value in equity.** Peripheral bonds and emerging markets could suffer in the short term. However, as the threat of much higher rates and a much stronger dollar are largely behind us, **this general repricing should be seen as an entry point (excluding idiosyncratic situations) for long-term investors**.

It is not time to be too defensive, but active, selective, risk-aware, and increasingly focused on capital preservation.

Amundi
ASSET MANAGEMENT

Important Information

AMUNDI INVESTMENT INSIGHTS UNIT

The Amundi Investment Insights Unit (AIIU) aims to transform our CIO expertise, and Amundi's overall investment knowledge, into actionable insights and tools tailored around investor needs. In a world where investors are exposed to information from multiple sources we aim to become the partner of choice for the provision of regular, clear, timely, engaging and relevant insights that can help our clients make informed investment decisions.

Discover Amundi investment insights at our website

www.amundi.com

Visit us on:

www.amundi.com

Amundi
ASSET MANAGEMENT