Confidence must be earned

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ASSET MANAGEMENT

INVESTMENT INSIGHTS BLUE PAPER | WINTER 2020

Economic resilience, Fed and elections to drive US markets in 2020

Dear client,

Kenneth J. TAUBES
CIO of US Investment Management

2019 proved a strong year for US assets, with US equity markets recording the strongest annual total return since 2013 and the US aggregate bond index up almost 9.0%. In addition, the past decade proved the best ever for the S&P 500 index, which returned 256% overall, well above its historical average. It was also the decade when US equities dominated other markets, with an outperformance of more than 90% versus the MSCI World index.

Despite such highs, we believe that US assets still offer compelling opportunities for global investors in 2020, though these are dependent on the evolution of three themes:

- The **resilience of private consumption** amid the expected US economic slowdown. Since private consumption accounts for about 70% of US GDP, it will be crucial to monitor this component. In our view, this will remain solid and is able to bear some labour market cooling.
- **Monetary policy trends,** as the Federal Reserve should not deliver an extra rate cut unless economic data disappoint, especially on the labour market front. Easy financial conditions should remain supportive of risky US assets.
- The **upcoming presidential election**, which will shape economic policies over the next four years, together with market trends and sector rotation throughout this year. The electoral campaign has already de facto started, in a tense climate due to the impeachment process, while democratic candidates are preparing for the primaries. 'Centrist' candidates (Biden, Buttigieg and Bloomberg) will oppose 'radical/social-Democratic' candidates (Warren, Sanders). This is the first time that radical proposals within the Democratic Party have been pushed by candidates who have a real chance of winning the primaries. A Trump re-election is far from certain and the evolution of his electoral odds could be a source of market volatility.

Our key convictions on US assets for 2020 are as follows:

- **US fixed income**: The range of Treasury yields will be wide this year, with yields possibly trending higher in the first part of 2020 as the economy reaccelerates, but lower in the second part of the year in the event of political tensions and decelerating growth. **Duration** should not contribute significantly to returns. We prefer a **neutral/short duration stance** to start the year and expect a **steepening of the yield curve**. Stabilising growth and the dovish Fed stance will support **credit markets**. However, investors should be cautious given the deteriorating micro fundamentals. As such, we favour **high-quality carry** with an increasing focus on liquidity. **HY is attractive on a selective basis**. **Securitised assets** offer carry opportunities and are attractive relative to most corporate bonds.
- **US equities: The bull market will continue, though soften,** and the electoral outcome will affect sector rotation and drive some volatility. **An acceleration in EPS growth** in the first half of 2020 should sustain the rally. Share buybacks should add about 2 pp to overall EPS growth in 2020. **One area that needs attention is the high market concentration:** the weight of the top five companies in the S&P 500 index has reached the highest level since 1999, at about 17%. Investors could mitigate this concentration risk by **increasing diversification** and focusing on bottom-up selection in cyclicals/value stocks.
- **From a cross-asset perspective,** equities are likely to offer higher return potential.

Fixed income: attractive yields in range-bound markets

Christine TODD
Head of Fixed Income, US

Sergio BERTONCINI
Head of Fixed Income Strategy

"The bottoming out of leading indicators is more likely than a widening in credit spreads."

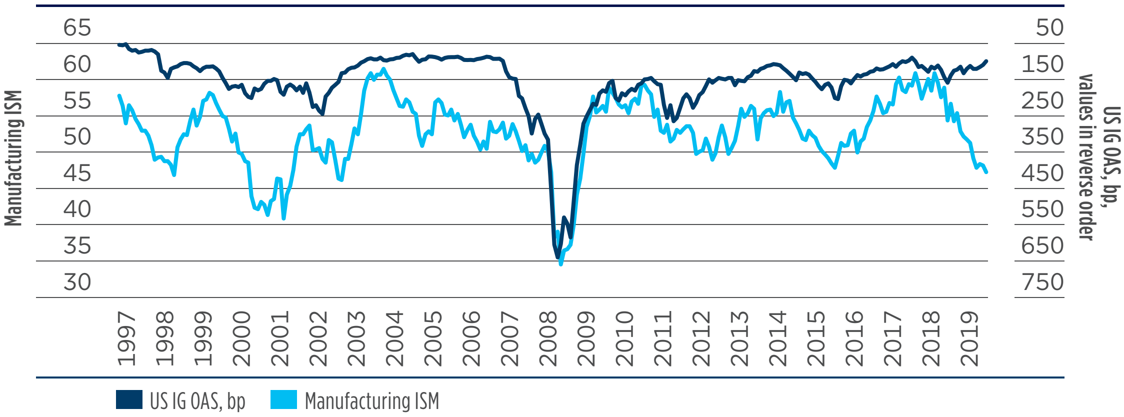
Following the three rate cuts agreed by the Fed last year, **the bar for delivering further accommodation is high**, and the central bank may be willing to allow some inflation overshooting (unlikely) before hiking rates. The renewed expansion of the Fed's *balance sheet* will keep financial conditions loose – even if it cannot be seen as a new round of QE – and will limit the upside pressure on rates. Politics will remain centre stage, with Trump's impeachment trial and the electoral campaign set to get under way later this year. The political attack on the Fed's independence should continue, with pressure on the central bank to cut rates further and weaken the dollar. The *10-year US treasury yield* is likely to trade in a wide range and remain dependent on macroeconomic and political risks. Overall, **we foresee limited upside on US yields**, with potential opportunities in a trading range and neutral duration positioning, with a focus on steepening.

In 2020 **US credit markets** will remain supported by benign **macroeconomic trends and technical factors**. On the former, the US economy is expected to grow more slowly this year but stay supportive for markets at – or slightly above – potential GDP growth. Regarding **technical factors**, neutral bank lending standards are supportive, together with low equity-implied volatility driving both HY and IG risk premiums. In addition, distress ratios – the share of HY bonds trading at spreads larger than 1,000 bp over government bonds – remain unthreatening.

However, **micro fundamentals are not as healthy**. **Valuations are tight** and getting even tighter due to the *search for income* in a low-yield environment for global fixed income, coupled with a **strong increase in outstanding corporate debt** over the past decade. Outstanding US IG corporate debt has increased from an estimated 2.3 trn USD in 2007 to 7.3 trn USD currently, and most of this expansion has occurred in the BBB-rated segment, which currently accounts for about 50% of the US IG market. **Valuations appear too high versus leverage metrics, especially among lower-rated IG issuers.** While this may not be a big deal in the short term, it is a risk for market trends in the longer run.

Over the course of 2019, spreads decoupled from macroeconomic leading indicators, failing to incorporate the higher risk premium consistent with the fall in confidence indicators. The most recent stabilisation of the Manufacturing ISM index, together with the positive news flow on global trade developments, bodes well for a reduction of this valuation gap. **Such a reduction is likely to be driven by the bottoming out of leading indicators rather than by a widening in credit spreads.**

Figure 1. Manufacturing ISM and IG option-adjusted spread, bp



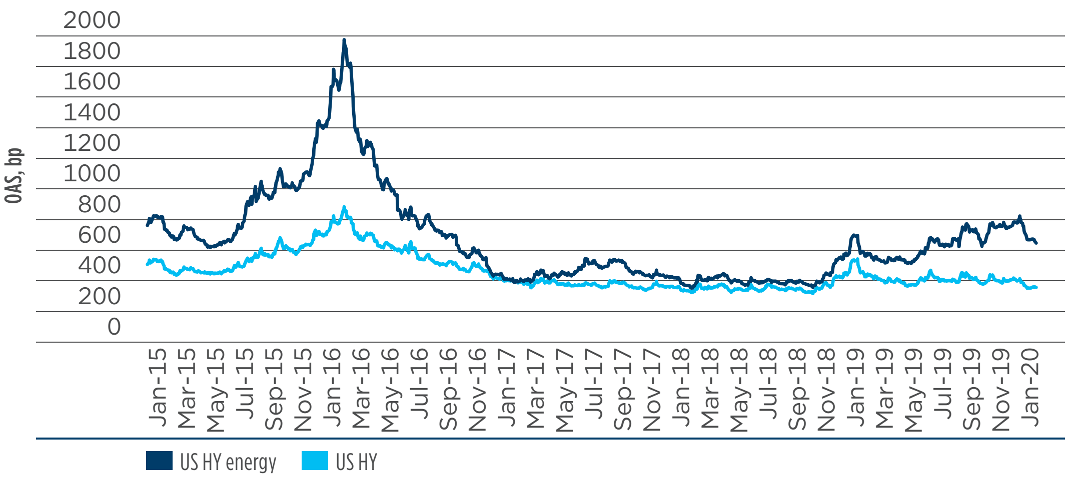
Source: Bloomberg, BofA-ML, Amundi Research. Data as of 7 January 2020.

Despite the dramatic rise in outstanding US IG debt, US corporates are cautious in managing their financial leverage, especially BBB-rated firms, to avoid being downgraded into the HY universe and to keep the cost of funding under control.

"In the HY universe, the decoupling between euro and US HY spreads has been mostly an energy story."

In the **HY universe,** the recent *decoupling* between euro and US HY spreads has proved to be mostly an **energy story**. If this sector is excluded, US HY trends stabilised last year, in line with trends in the European HY market, while the energy sector showed signs of distress. Of the 64 defaults recorded globally over the first nine months of 2019, 19 – or 30% of the total – were in the energy sector, according to the latest Moody's report on defaults. The energy sector's share of defaults was 19% over the same period of 2018. The key reason for the deterioration was the plunge in oil prices at the end of 2018, which weighed **on both the default rate and the distress ratio of the sector.**

Figure 2. US HY option-adjusted spreads, bp



Source: Bloomberg, BofA-ML, Amundi Research. Data as of 7 January 2020.

"The combination of supportive macro fundamental trends and tight valuations calls for high selectivity in credit markets."

The combination of supportive macro fundamental trends and tight valuations calls for high selectivity in credit markets. Fixed income investors should seek opportunities across multiple sectors, with a focus on diversification and liquidity. Investing in **securitised credit sectors,** including asset-backed securities, commercial mortgage-backed securities (ABS) and residential mortgage-backed securities (RMBS), is consistent with this approach. These sectors are attractive when considering their relative valuations, strong credit protection, US consumer focus and lower exposure to global growth risks. **Agency mortgage-backed securities** are attractive relative to US Treasuries after the recent spread widening.

Table 1. Role of US fixed income in a global portfolio

Rationale	Opportunities
Total return opportunities	US fixed income offers attractive return opportunities, as Treasuries enjoy appealing yield differentials compared with other bonds. It is a mature and diversified market that offers opportunities in a broad range of asset classes, including securitised assets. Such returns remain attractive despite the hedging costs for euro-based investors, currently at 2.4%.
Liquidity and diversification	As the largest government bond market globally, US govies offer diversification opportunities vs equities, while warranting high liquidity levels.

Source: Amundi, as of 7 January 2020.

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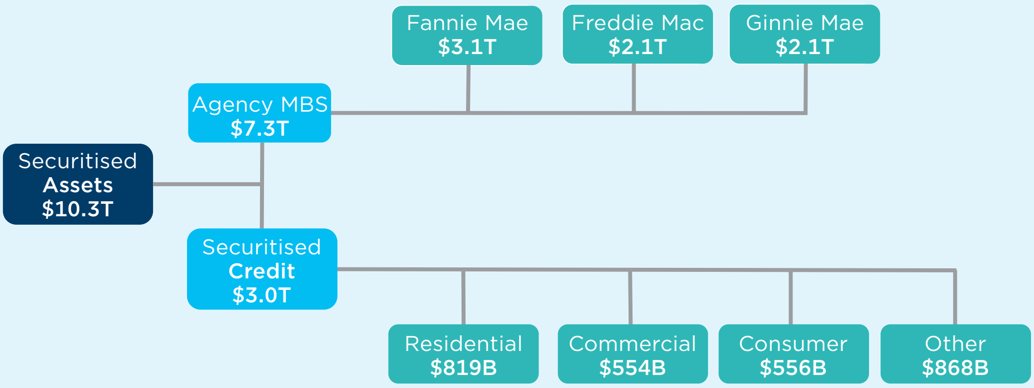
Beyond traditional credit: securitised assets in focus

Noah FUNDERBURK
US portfolio manager

Securitised assets offer search-for-yield opportunities in 2020. They are financial instruments where cash flows are derived from and secured by specific underlying collateral. In a securitisation, assets are sold into a trust, which then issues securities backed by those assets. Securitisations include bonds backed by residential mortgages, commercial mortgages, automobile loans, credit cards, bank loans made to corporations and other assets. By assigning different payment priorities to each bond within a securitisation, investors can access a menu of risk and return options in terms of both interest rate risk and credit risk. The most common securitisation is the mortgage-backed security (MBS), where residential loans serve as the collateral. Within the MBS market, the largest sector is agency MBS, with these akin to the covered bonds issued by the government-sponsored enterprises Fannie Mae, Freddie Mac and Ginnie Mae. Agency MBS differs from private-sector securitisations because they offer an explicit or implicit guarantee from the US government. In contrast, individual investors are responsible for the credit risk embedded in the higher-yielding segment of residential, commercial, consumer and other securitised credit.

Figure 3. Market of US securitised assets and respective size



Source: SIFMA, eMBS, Amundi. Data as of Q2 2019.

Securitised assets were at the epicentre of the 2008 global financial crisis. **Thanks to stronger consumer balance sheets and the market reforms that have taken place since then, it is unlikely that securitised assets will cause the next crisis.** The backward-looking bias often embraced by investors explains the current disconnect between risk premiums and fundamental risk. Today, US household debt service costs are at their lowest levels since 1980 and the US savings rate is above its long-term average. Amid a weakened global growth environment, the US consumer has remained resilient. For this reason, fixed income investors can benefit from investments in securitised credit sectors that are supported by the financial health of the US consumer. **Yields in the agency MBS market offer an attractive entry point versus Treasuries.** While agency MBS have little to no credit risk because of the explicit or implicit guarantee from the US government, the expected returns on these securities are higher than comparable duration US Treasuries due to the prepayment option of the underlying borrowers. Investors are compensated for taking this prepayment risk. With the recent decline in interest rates, investors are overpricing the risk of these prepayments, and spreads appear dislocated compared with IG corporate bonds. Refinancing rates between different agency MBS sectors have diverged due to technological and systemic enhancements in the mortgage origination industry, but **careful security selection can mitigate these risks and potentially lead to excess returns.** Securitisations are believed to be illiquid but agency MBS and high-quality ABS offer investors liquidity second only to US Treasuries, while higher-yielding securitised assets can exhibit lower liquidity than comparably rated corporate credit, due to their smaller issuance size and lower transaction volumes. Like any investment strategy, it is critical to price this risk and match the liquidity of the assets with the liquidity of the investment vehicle and the investment goal.

"Yields in the agency MBS market offer an attractive entry point versus Treasuries."

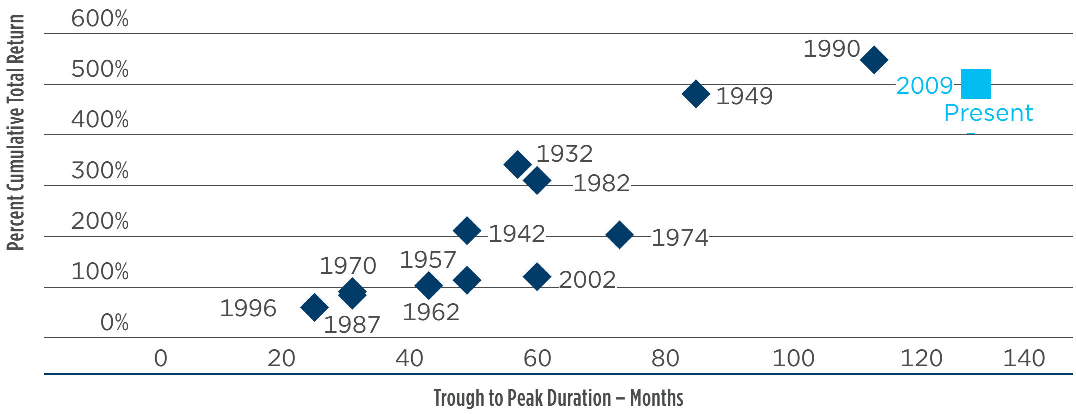
US equity bull market should continue, but soften

Marco PIRONDINI
Head of Equities, US Portfolio Manager

Eric MIJOT
Head of Equity Strategy
Deputy Head of Strategy Research

The US equity market is entering 2020 in the longest bull run in history, though not the strongest. In terms of cumulative total return, the current bull market ranks second only to the expansionary cycle that started in 1990.

Figure 4. The longest bull market and the second strongest in history

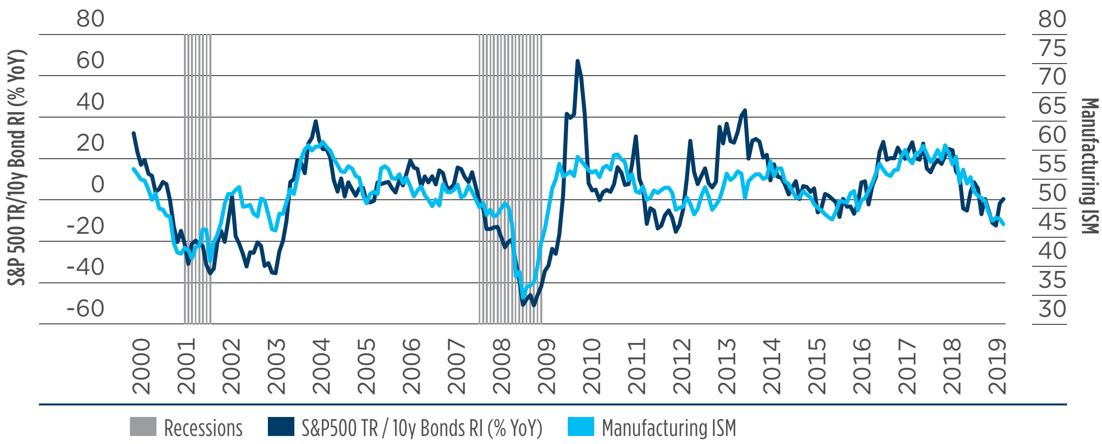


Source: Bloomberg (data on S&P 500 index) and Amundi. Data as of 7 January 2020. Trough to peak duration: the stage of the market cycle from its cyclical bottom (trough) to a period of growth (peak).

To assess if such a trend will continue this year, monitoring the developments of the Manufacturing ISM index will be crucial. We should bear in mind that in a scenario of slow consumption and inflation, low official rates and low bond yields, **the Manufacturing ISM and equity markets show high correlation**. The Fed delivered three rate cuts in 2019. Since monetary policy operates with lags on the real economy, **the Manufacturing ISM index could bottom out over the next few months, allowing the US bull market to run throughout 2020**. The favourable geopolitical landscape – should it be confirmed as in our main scenario – will provide a window of opportunity, at least until the electoral campaign for the upcoming presidential election officially gets underway.

"The Manufacturing ISM index could bottom out over the next few months, allowing the US bull market to continue throughout 2020."

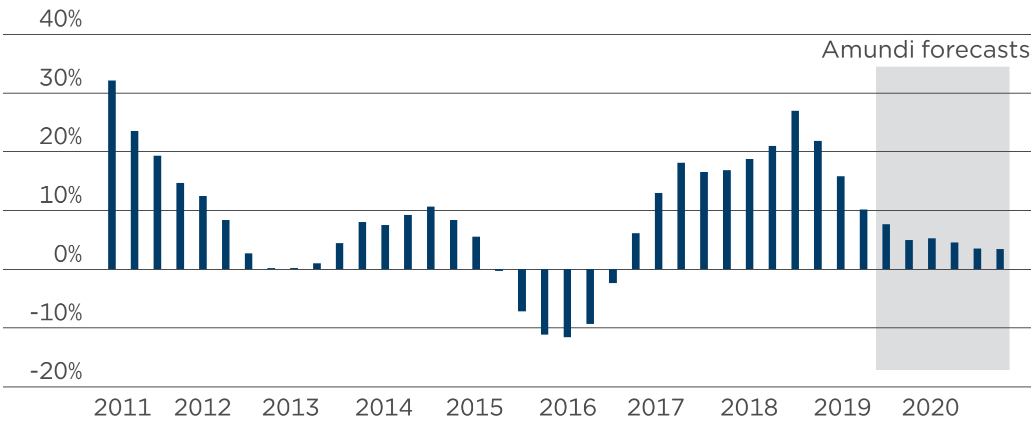
Figure 5. Manufacturing ISM and US equity/bonds



Source: Amundi Research, analysis on Bloomberg data as of 7 January 2020. S&P 500 index is in total return terms. For 10y bonds, coupons are reinvested.

At 10% YoY, the 2020 IBES forecast for US earnings growth is somewhat optimistic, in our view. Over the past 10 years, such consensus has been constantly downgraded as the year progresses and this year should be no exception. We expect US earnings growth to be mid- to high-single digit, aided by a recovery in manufacturing activity. Earnings growth will also be helped by easy comparisons in some cyclical sectors, such as energy and materials, where earnings were depressed in 2019.

Figure 6. S&P 500 EPS growth is likely to be mid-to high-single digit in 2020



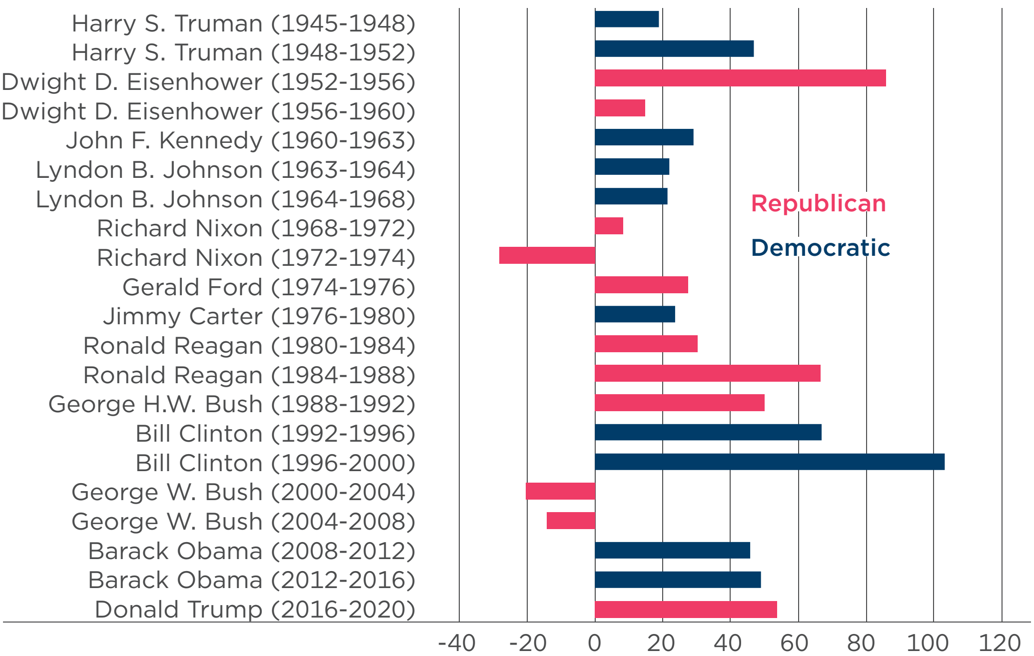
Source: Amundi Research, analysis on Bloomberg data as of 31 October 2019.

"EPS growth will benefit from share buybacks, which will contribute 2% to overall EPS growth in 2020."

P/E ratios are reasonable when factoring in the low interest rate environment and should support equities further early in the year. Later on, an acceleration in EPS growth should cause equities to move higher. **EPS growth will benefit from share buybacks, which we estimate will contribute 2% to overall EPS growth in 2020.**

Finally, investors should monitor the upcoming run-up to the 2020 presidential election. Since World War II the US equity market performance has been shaped primarily by the business cycle momentum and secondly by economic policies pursued under different presidents, **as different policies may cause sector/single stock rotation.**

Figure 7. S&P500 price return performance over each presidential term, %



Source: Bloomberg data on S&P 500 index and Amundi, as of 7 January 2020. President Roosevelt died in office on 12 April 1945 and Harry S. Truman took office on the same day. President Kennedy died in office on 23 November 1963 and Lyndon Johnson took office on the same day. President Nixon resigned from office on 9 August 1974 and Gerald Ford took office on the same day.

"After the strong 2019 rally, equities could still move higher but selectivity will be key given high valuations in some defensive sectors."

Our main scenario is exposed to **a few low probability risks**, including:

- Geopolitical developments could prove more fragile than anticipated and the long-term relationship between China and the United States could deteriorate;
- Other international geopolitical risks could flare up (e.g., Turkey, Middle East tensions);
- US domestic political developments could prove adverse and include Trump's possible, but unlikely, removal from office and/or the emergence of a populist Democratic candidate;
- Deteriorating US domestic economic growth, with weak manufacturing and services sector performance.

Table 2. Key bottom-up themes in US equity market for 2020

Industry/Theme	Rationale
Cyclical stocks are favoured over defensive ones	Investors favoured defensive stocks in 2019 due to trade fears and falling interest rates, which resulted in a search for yield in sectors such as REITs and utilities. Cyclical sectors, by comparison, did not fare well due to slowing global growth. As a result, valuations are more attractive in cyclical sectors than in defensive sectors. A resolution of the trade issues with China, Canada, Europe and Mexico, coupled with a recovery in manufacturing activity, **could cause growth to reaccelerate and cyclicals to outperform in 2020, with defensive sectors lagging**.
Financials to benefit from cyclical upswing	**Financials should be among the biggest beneficiaries if economic growth reaccelerates**. The yield curve, which was inverted for part of 2019, has already steepened in anticipation of stronger growth. This is positive for banks as they lend at long-term rates and borrow at short-term rates. Credit quality remains high as unemployment is low and wages are slowly rising.
Specific consumer/ retail	The US consumer segment is healthy, thanks to job and wage growth. We favour companies that have been able to prosper even in an increasingly e-commerce-dominated retail landscape, such as **off-price retail, home improvement and membership warehouses**. A critical success factor for these companies is the ability to manage margins, with wages, logistics and complexity costs trending higher.
Structural winners in tech, with decent valuations	Though technology stocks performed well in 2019, there are still selective opportunities in the sector, specifically **those companies with strong secular tailwinds such as the adoption of cloud infrastructure and applications**. A recovery in economic growth would also benefit segments of technology that are economically sensitive, such as semiconductors. The semiconductor industry has consolidated, making the downturns less severe and recoveries more sustainable.
Healthcare volatility is likely	**The sector is likely to be volatile as the presidential election season gets under way**. Progressive Democrat candidates favour healthcare reform, which is likely to negatively impact health insurers and the pricing of biotechnology and pharmaceutical products. **Medical technology stocks are a safer haven**, in our view, within the healthcare sector given the low likelihood that healthcare reform would impact their businesses.
Utilities appear overvalued	Valuations are excessive in some cases as investors have been willing to pay up for stability and income. In a low interest rate environment, regulators may opt to lower the allowed rate of return for utilities. **The sector is also vulnerable to the shift to alternative energy**.

Source: Amundi, as of 10 January 2020.

US economy to stabilise, supported by resilient domestic demand

Annalisa USARDI
Senior Economist

Following the 2019 slowdown, US economic growth will stabilise around potential consumption will be the main driver, while investment will prove weak. Core inflation will stay on a mild upward trend, as the positive output gap supports domestically generated inflationary pressures. Headline inflation is likely to accelerate in the first half of 2020 and moderate later, with headline CPI estimated to pick up at an average of 2.3% from 1.8% in 2019. Under such a scenario, the Fed could deliver an extra rate cut this year should data deteriorate further, but the bar for delivering further accommodation is high. Such an outlook relies on a set of assumptions:

- On **trade**, we assume no further escalation in the US-China trade dispute, with an extension of the status quo. Global trade growth will rebound somewhat from the 2019 lows and then stabilise at a lower growth pace than in the past.
- On **fiscal policy**, we expect the current split Congress to deliver no additional fiscal stimulus. Further stimulus is more likely in 2021 following the presidential election and conditional on its outcome.
- On **monetary policy**, the Fed delivered significant easing last year and rates are now below their estimated neutral level. An extra cut could come in the case of disappointing economic data, in particular on the labour market front. The latest Fed *summary of economic projections*, released in December, and included growth and inflation forecasts that could prove overly optimistic.
- On **geopolitics**, we do not expect any disruptive events that could raise uncertainty and have negative spillover effects on confidence this year. On the domestic front, as the Democratic candidate will be chosen by mid-year, markets may react to this nomination, especially should the candidate be perceived as market unfriendly.

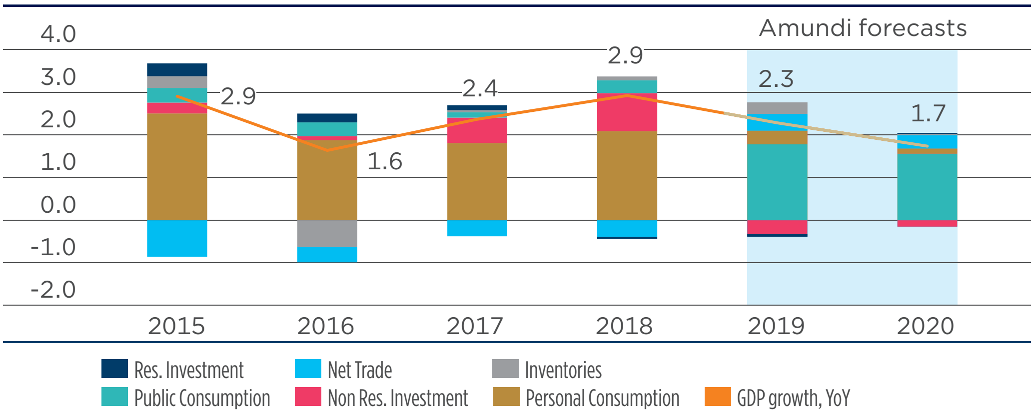
"We expect no additional fiscal stimulus to be passed on top of the package delivered in 2017."

2020 growth outlook

We expect the US economy to decelerate this year, with growth of 1.7% taking it towards its long-run growth potential, down from the peak hit in Q2 2018. This is due to the bulk of the positive impact from the fiscal stimulus delivered by the 2017 Tax Cuts and Jobs Act and the easier monetary policy having faded. The output gap, which closed in mid-2018, according to the Congressional Budget Office, will stay positive until mid-2021, with GDP growing above its potential and supporting core inflation to uptrend gradually (we estimate the core PCE deflator will average 1.9% in 2020, up from 1.6% last year).

"US economic growth will decelerate to 1.7% this year from its peak, hit in Q2 2018."

Figure 8. Contribution to change in US real GDP growth, percentage points



Source: Amundi Research, Datastream. Data as of 29 November 2019.

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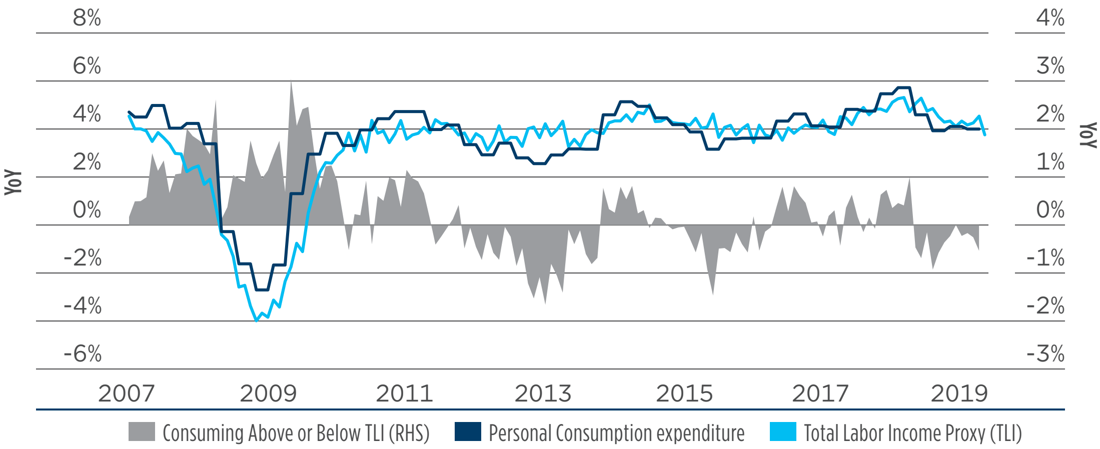
"In 2020 US growth will be driven by domestic demand."

Growth will be driven by domestic demand. Private final demand – which includes private consumption, investment and stock building – has responded strongly to lower interest rates, particularly in interest-rate sensitive segments such as housing and consumer durables. **Private consumption trends will be key**. While interest rates remain supportive, their impulse will have increasingly lower marginal impact. The relative strength of US household balance sheets – which have been cleaned up following the Great Financial Crisis – could be a cushion in case of deteriorating labour market conditions. Meanwhile, rising inequality in wealth distribution makes some segments of the population more vulnerable, especially lower-income households, which remain the weak link as they are particularly exposed to a possible deterioration in labour market conditions. This may limit the recovery of private consumption this year.

Figure 9. Private consumption and labour income growth, %



Source: Amundi Research, Datastream. Data as of 7 January 2020.

"The labour market appears resilient, with low unemployment, strong hours worked and moderate wage growth."

The labour market appears resilient, with low unemployment, strong hours worked and moderate wage growth. However, a few signs of deceleration are appearing, as hires, quits and separations have plateaued at cycle highs, while job openings are declining. In addition, the duration of unemployment is increasing, flagging the risk that the jobs market could be losing momentum, albeit is still cyclically strong. As aggregate income growth slows, personal consumption growth will soften as a consequence. **The overall resilient consumption pattern is counterbalanced by the weakness in manufacturing and capex**, which is expected to persist into 2020. These diverging trends are highlighted by the *Q4 2019 Fed Senior Loan Officer Survey*, according to which demand for commercial and industrial loans has weakened notwithstanding stable lending conditions, while demand for loans to households has strengthened for most categories, even against the tightening standards in credit card loans.

Regarding **fixed investments**, **their weakness has been related to global factors**, with policy-related uncertainty weighing on US business confidence. This uncertainty has long-lasting decelerating effects on key components of non-residential investments, including structures and equipment investment. In 2020 the uncertainty will remain and will pivot from trade issues to the upcoming presidential election, preventing a meaningful improvement in non-residential investment trends, especially in the context of slowing private consumption. Moreover, as tariff-related and domestic pressures drive input prices higher, corporate margins may come under pressure, limiting capex spending capability.

On **residential investment**, **we do expect some improvement** as it benefits from lower interest rates. Finally, **net trade is expected to marginally drag** from growth in 2020 after having shaved 0.3% in 2019 as a whole, according to our estimates.

Focus on 2020 presidential election

Paresh UPADHYAYA
Director of Currency Strategy, US Portfolio Manager

On 3 November the United States will hold a presidential election, an event that could impact the global economy and financial markets. While the political fundamentals favour a Democratic candidate over President Trump, the economic fundamentals help level the playing field. Ultimately, the US presidential election will either be determined by President Trump's handling of the economy and labour market or it will become a referendum on impeachment and concerns over Trump's moral proclivities. We see a 50% chance of the Republican Party retaining control of the White House, with four possible scenarios to unfold:

- **Trump re-elected (45% chance):** The economy remains robust and Trump's style of politics boosts the unfavourable ratings of his Democratic opponent – the classic lesser of the two evils, a repeat of the 2016 election. A weak Democratic nominee could make this task easier.
- **Another Republican nominee (5% chance):** In a scenario where scandal envelops Trump, forcing him to resign, he is forced out of office or he does not run for re-election, the Republican Party will have to find a replacement nominee. The most obvious choice would be Vice President Michael Pence, but other prospective candidates should be considered as well, including Utah Senator Mitt Romney.
- **Established Democrat (30% chance) such as Joe Biden:** The US economy slows and Trump's approval rating falls below 40%; the election becomes a referendum on impeachment.
- **Populist Democrat (20% chance) such as Bernie Sanders or Elizabeth Warren:** The economy slumps into recession, increasing fatigue about the ongoing scandals plaguing Trump, and disenchantment about income inequality feeds the narrative for a seismic shift for change.

The election outcome will evolve around a few factors:

"US GDP growth has averaged a solid 2.6% so far in Trump's term, one of the strongest growth rates since Clinton's 4.5% in his second term."

- **Economy/labour market:** This is one of the few areas where Trump has polled consistently well so far. It is also the most important factor for him to be re-elected. Trump's approval ratings for his handling of both the economy and jobs generally remain favourable. US GDP growth has averaged a solid 2.6% so far in Trump's term, one of the strongest growth rates since Clinton's 4.5% in his second term. If the economy keeps growing above trend and the unemployment rate remains around 4.0%, voters may vote to re-elect Trump.
- **Referendum on impeachment:** Following the House of Representatives' vote to impeach President Trump on charges of abuse of power and obstructing Congress, we expect him to be acquitted in the Senate trial. The strength of the economy should help Trump win a second term, but concerns over the impeachment could overshadow the strong economic performance. Concerns on whether Trump broke the law could force voters to express their displeasure against him rather than voting for the economy. The nation remains divided, with a slight plurality of 47.8% in support of the impeachment inquiry and removal from office while 46.1% disagree, according to polls in December 2019.
- **Democratic opponent:** Trump's Democratic opponent will also have an impact on his re-election. We believe an establishment Democratic candidate would have a better chance of defeating Trump than a populist one. There is a divide within the Democratic Party between candidates embracing progressive policies such as 'Medicare-for-all' and those calling for moderate incremental changes to policies such as healthcare. The Democratic electorate will pivot between the issues that matter the most to them and electability. The latter has been the key motivating factor thus far. According to a Fox Poll taken on 15-17 September, 56% of Democratic primary voters support the

candidate they feel has the best chance of beating Trump, while only 31% support the candidate they like most. It would probably take a US recession or profound social upheaval for US citizens to elect a populist Democratic candidate.

"We expect a Democratic House and a Republican Senate out of the 2020 Congressional election."

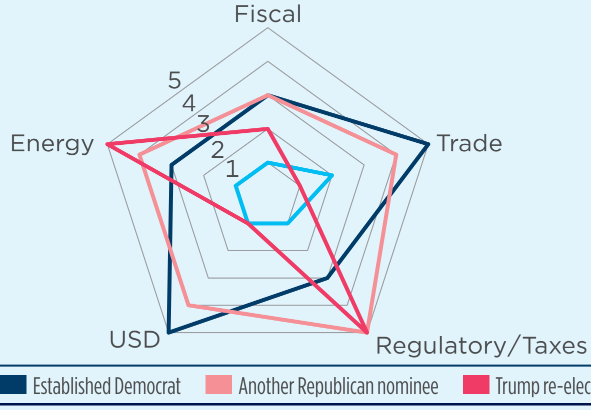
2020 Congress election

This year US citizens will also vote to renew all 435 members of the House of Representatives and 35 Senate seats. **We expect the outcome to be for a Democratic House and a Republican Senate.** In the **House of Representatives**, Republicans need to win 18 seats to regain the majority, while retaining two vacant Republican seats. The *Cook Political Report* currently rates 18 Democratic seats as 'toss-ups', while only five Republican seats are considered toss-ups. The Republican Party would need to sweep each of the Democratic toss-ups while losing none of their own – a tall order. It remains an uphill battle for the Republican Party to take over the House for two reasons:

- The number of Republican retirements is soaring, hitting 18. Presumably, Republican representatives would not be retiring unless they viewed the prospects of regaining the majority as challenging.
- In our analysis of the election cycles, the House majority has not flipped twice in a row since 1954.

In the **Senate**, the Democrats need three seats to gain a majority if they win the Presidency – the vice president breaks a tie if the Senate is 50/50 split – and four seats if they do not win the presidency. While the Republican Party has the advantage, the **Democrats have a fighting chance of taking the majority if everything goes their way**. Republicans have more seats to defend – 23 vs. 12 – but most of their seats are in their strongholds. We estimate there are three Republican toss-up seats, while only one Democratic seat is expected to change party. **The markets may be underestimating the recent trend of partisan voting, whereby there is less ticket splitting**, which happens when traditional Democratic or Republican voters vote for one party in the national election but vote for the other party in the local races. **This means there is a greater likelihood that the state winner on the president's side will most likely win the Senate race**. This could indicate a tighter contest. Overall, the market impact will be favourably disposed from Trump's campaign platform on energy and regulatory/tax policy, while negatively disposed to his fiscal, trade and dollar policy. On the other hand, the market is likely to react most bullishly to a potential GOP nominee's stance on all the key issues, except fiscal. On the Democratic side, the market is likely to react more positively to the establishment Democratic agenda rather than the populist one (see Figure 10).

Figure 10: Impact on policy issues of different election outcomes (1 being the least favourable and 5 the most favourable)



Source: Amundi. Data as of 7 January 2020.

Investment implications of possible election outcomes

Scenario	Policy background	Market impact
Trump re-election 45%	Trump has been supportive of energy output, rolling back regulations and passing the 2017 Tax Cuts and Job Acts. Further action can be expected on taxes in a second term. There is no plan to reduce the size of the budget deficit and there may be a further rise on infrastructure spending. Trump has called for a **weaker USD** and free and fair trade. **He could implement more protectionist policies if re-elected**.	Equity markets are likely to benefit from a strong economy. The **infrastructure, defence, energy, financials and telecom** sectors will win. **Interest rates** could rise due to strong growth and rising inflation as the Fed restarts tightening. The **USD** will stay strong as the Fed's tightening keeps interest rate differentials in favour of the USD.
Another Republican nominee 5%	There is unlikely to be any difference from President Trump on the energy and regulatory/tax front. However, the standard party bearer is likely to resort to the party's historic position on **free trade and tolerating a *laissez faire* policy on the USD**. On the fiscal side, there is **no plan to reduce the budget deficit.**	Healthy growth, making the tax cuts permanent, capital gains indexing and reduced trade tensions will **support equity prices**. A neutral Fed policy is likely to keep interest rates consolidated in a wide range. While stable interest rate differentials mean a stable USD, the latter is more likely to be influenced by developments overseas. A recovery in global growth will help send the **USD into a bear market**.
Establishment Democrat 30%	***Laissez-faire* policies** are likely on the USD and the United States could re-enter into **TPP** talks. S/he could reverse **Trump's tax cuts**. **Greater regulation** of the tech sector and antitrust enforcement are likely. There is no plan to reduce the budget deficit. On energy, there could be a renewed effort to **promote renewables** but restrict energy investment offshore and on federal land. There could be some restrictions on fracking.	The stock market could rebound as growth improves. The **tech, pharmaceutical and healthcare sectors** are likely to underperform, while **renewable energy and transportation** will outperform. **Interest rates** will stay range-bound as stable growth and soft inflation keep the Fed on hold. The global convergence in growth and monetary policy will drive the **USD lower**.
Populist Democrat 20%	Populist candidates have advocated a more managed USD policy to promote exports and foster domestic manufacturing. Some have called for monitoring currency manipulation. **More interventionist policies are likely in regulatory/taxes**. Programmes such as 'Medicare for All' will weigh on the **budget deficit**. On energy, **restrictions are likely on coal and oil**, while promoting renewable energy.	Below-trend growth and a populist agenda will lead to a **negative environment for equities. Tech, pharmaceutical, energy, defence, and healthcare sectors** are likely to underperform while the **construction, transportation and resource stocks** will outperform. Interest rates rally **as Fed eases** policy but as concerns about stagflation emerge, the curve steepens. The negative outlook on US asset prices and narrowing interest rate differentials lead to a USD depreciation.

Source: Amundi. Data as of 7 January 2020.

Definitions

- **ABS:** Asset-backed securities. These are financial securities such as bonds, which are collateralised by a pool of assets, possibly including loans, leases, credit card debt, royalties or receivables.
- **Asset purchase programme:** A type of monetary policy wherein central banks purchase securities from the market to increase money supply and encourage lending and investment.
- **Basis points:** One basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Bond ratings:** Source: Moody's and S&P. If the ratings provided by Moody's and S&P for a security differ, the higher of the two ratings is used. Bond ratings are ordered highest to lowest in portfolio. Based on S&P measures: AAA (highest possible rating) through BBB are considered investment grade; BB or lower ratings are considered non-investment grade. Cash equivalents and some bonds may not be rated.
- **Credit spread:** Differential between the yield on a credit bond and the Treasury yield. The option-adjusted spread is a measure of the spread adjusted to take into consideration possible embedded options.
- **Curve steepening:** A steepening yield curve may be a result of long-term interest rates rising more than short-term interest rates or short-term rates dropping more than long-term rates.
- **Default rate:** Percentage of issuers that failed to make interest or principal payments in the prior 12 months. Default rate based on BofAML indices. Universe consists of issuers in the corresponding index 12 months prior to the date of default. Indices considered for corporate markets are ICE BofA-Merrill Lynch.
- **Diversification:** Diversification is a strategy that mixes a variety of investments within a portfolio, in an attempt at limiting exposure to any single asset or risk.
- **Duration:** A measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates, expressed as a number of years.
- **Fallen angel:** A fallen angel is a bond that was given an investment-grade rating but has since been reduced to junk-bond status due to the weakening financial condition of the issuer.
- **MBS, CMBS, ABS:** Mortgage-backed security (MBS), commercial mortgage-backed security (CMBS), asset-backed security (ABS).
- **Option-Adjusted Spread (OAS):** The measurement of the spread of a fixed-income security rate and the risk-free rate of return, which is adjusted to take into account an embedded option.
- **Purchasing Managers' Indices (PMI):** Purchasing Managers' Indices (PMI) are economic indicators derived from monthly surveys of private sector companies. A reading above 50 indicates an improvement, while a reading below 50 indicates a decline.
- **Quantitative Easing (QE):** QE is a monetary policy instrument used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.
- **REIT:** A real estate investment trust (REIT) is a company owning and operating real estate which generates income. Most REITs specialise in a specific real estate sector, focusing their time, energy and funding on that particular segment of the real estate horizon.
- **RMBS:** A residential mortgage-backed security (RMBS) is a debt-based security backed by the interest paid on loans for residences. The risk is mitigated by pooling many such loans to minimise the risk of an individual default.
- **Rising star:** A rising star company has a low credit rating, but only because it is new to the bond market and still establishing a track record. It does not yet have the track record and/or the size to earn an investment-grade rating from a credit rating agency.
- **Spread:** The difference between two prices or interest rates.
- **Toss up:** 50-50 chance.
- **Volatility:** A statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.

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With the contribution of

Claudia BERTINO
Head of Amundi Investment Insights Units

Francesca PANELLI
Amundi Investment Insights Unit Specialist

AMUNDI Investment Insights Unit

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Chief Editors

Pascal BLANQUÉ
Chief Investment Officer

Vincent MORTIER
Deputy Chief Investment Officer

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