Amundi ASSET MANAGEMENT
AMUNDI Equities
The equity network letter

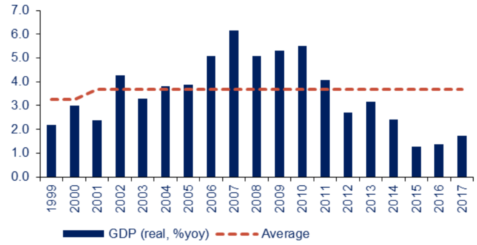
January 2016 – n°46

editorial

Domestic Versus the Rest of the World

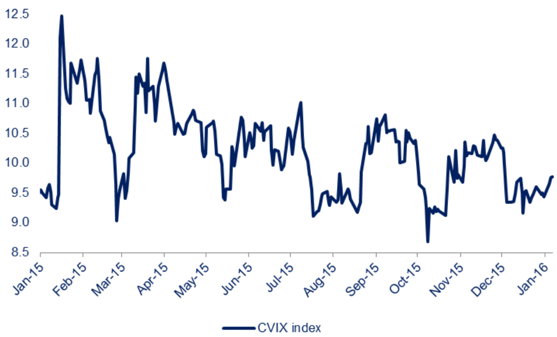
When we look at a planisphere, wherever we may be located in the world, the centre is where we are. In other words, the implicit conviction is that wherever one may be, one is always at the centre, which is the best position to be in. Today, we can make more or less the same observation regarding the economy and equity markets. Global trade is decelerating and growing in line with if not at a slower pace than world economic growth, and the competitive edge of emerging markets, starting with China, relative to developed economies has largely disappeared. Last but not least currency volatility has started to move up dramatically, and we are far from the end of the story.

Growth differential between Emerging and Developed Countries



Source : EIU, MSCI, Amundi

Implied volatility of currency markets



Source :Bloomberg

Once again, the adjustments are coming from quantitative rather than qualitative easing, and from currency movements rather than from cross border interest rate differentials. A natural consequence of this development is the need for equity investors to pay greater attention to currency movements which can neutralise or on the contrary massively improve the lower returns expected from risky assets this year. Another consequence is the decline in investor appetite for emerging market assets because of a narrowing growth differential and increased currency risks. Nevertheless, today there is a clear value case to be made in favour of emerging market equities.

One of the key adjustment variables, as illustrated by depressed commodity prices, is that we are no longer relying on the rest of the world to fuel economic growth, and are focusing far more on domestic consumption, especially in developed countries. This domestic bias is typical of turbulent times. In our scenario, we cannot bet against this rule, because even though we are expecting slightly higher returns in emerging markets than in Europe, Japan or the US, in reality the gap in absolute returns between the different markets has narrowed considerably. Above all, if we look at risk adjusted returns, developed markets, staring with Europe followed by Japan, are once again slightly ahead of emerging markets.

Romain Boscher
Global Head of Equities

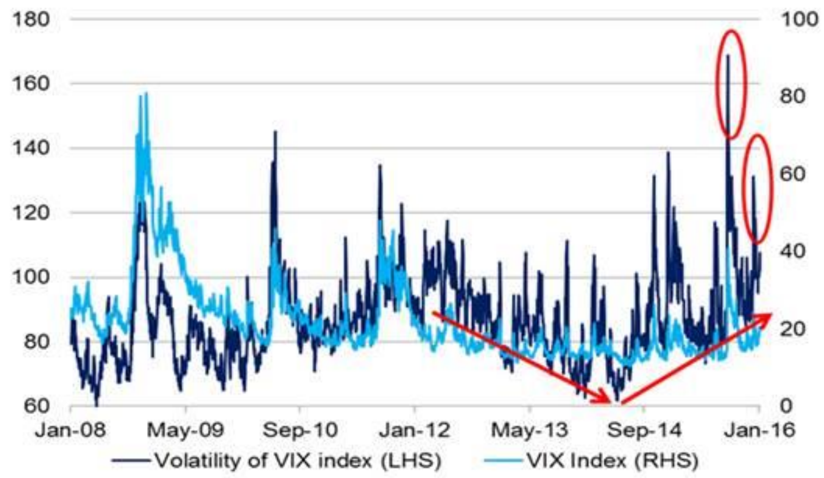
convictions

Volatility: towards a structurally higher volatility regime

2015 has shown us that volatility has become more durably volatile. Spikes in volatility are becoming more frequent and of shorter duration. This can be largely explained by the impact of products like ETPs which have to buy volatility when volatility is rising and sell when volatility is falling, as well as by risk constraints of certain market players in periods of stress. In this environment, a dynamic and contrarian management of volatility exposure is necessary to generate performance.

However, in view of the numerous elements of uncertainty currently weighing on emerging markets (economic transition, oil, geopolitics, etc.), along with shrinking liquidity in certain markets, an increasing number of investors are seeking protection from a possible contagion spreading to developed markets. Thus going forward, we are likely to see a general and across the board rise in volatility, which will be pronounced and above all last longer, because of a lack of sellers.

More frequent spikes in volatility



Source : Bloomberg

Eric Hermitte & Gilbert Keskin
Co-Heads of Volatility and Convertibles

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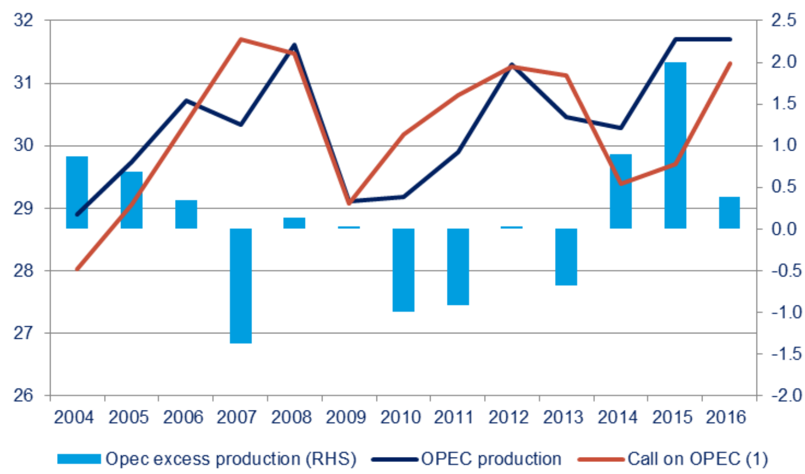
Oil: gradual return to equilibrium

The oil price (Brent) plummeted 38% in 2015, and has plunged 68% since June 2014. The Opec meeting of November 2014 marked a change in Saudi Arabia's oil policy, with priority given to maintaining market share against rising non-Opec production, especially in the US, but also against the future increase in Iranian production (once the sanctions are lifted). Tensions between Saudi Arabia, Iran and Russia (Syria, Yemen) probably also explain Saudi Arabia's new production policy.

A less unbalanced oil market in 2016



(1) World demand – non-Opec production

Source:IEA, CPR

On the basis of the forecasts of the International Energy Agency, we can estimate that the overproduction in the oil market in 2015 amounted to 2 million barrels per day, equivalent to 2.2% of the market. In 2016, the market should remain in overproduction, but at a lower level estimated at 0.4 million barrels/day; because of higher demand and a fall in US production, after the surge of the past few years (development of shale oil). Despite lower production costs, the plunge in the oil price is forcing oil companies to make drastic cuts in capex. This will feed through to a fall in production in the US from this year (short production cycle in shale oil) and from 2017 in other countries. The funding problems faced by some oil companies, especially in the US where corporate bond yields have surged spectacularly, could even lead to bankruptcies and a more rapid downward adjustment in oil production.

The direction of Iranian production remains a major uncertainty. Iran could increase its production by 0.5 million barrels/day as early as this year. A return to the production levels of 2012-2011 would imply an increase of nearly 1 million barrels/day. This would push back the return to equilibrium of the oil market from end 2016 to 2017-2018.

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Lastly, the geopolitical situation remains a “traditional” source of uncertainty on oil markets. Risks for 2016 include conflicts in Syria and Yemen, tensions between Saudi Arabia, Turkey, Iran and Russia and the possibility of domestic unrest due to the decline in revenues of oil exporting countries.

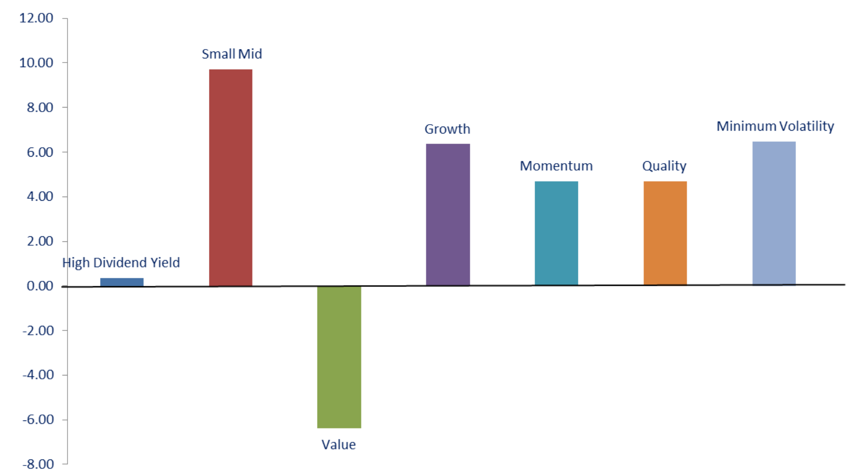
Stéphane Soussan
Portfolio Manager, Global Thematics, CPR-AM

How long will Smart beta be smart?

Equity markets have been very challenging during the last decades: international indices often shifted from extraordinary bull market conditions to prolonged drawdowns with high realized volatility. Such a background stimulated discussions over traditional market cap weighted indices and led to the introduction of “smart beta” strategies and their rapid development. Smart beta strategies typically weight stocks according to risk metrics such as volatility, correlation and contribution to volatility.

Those strategies have proven to be more efficient than market capitalization indices from a risk-return standpoint. Their returns over the last decade are at least equal to and very often higher than those of standard indices, while volatility and drawdowns are systematically lower. Because of their low risk profile, Smart beta strategies are usually discussed together with the outperformance delivered in the last 10-15 years by low risk stocks. As a consequence, answering the question «How Long will Smart beta be smart?», is implicitly linked to making an assessment on how long the low risk anomaly will persist.

Factor contribution to performance in 2015
Performance relative to MSCI Europe (as of 31 Dec. 2015)



Source: Factset

On one hand, we believe that there is no strong argument for the low risk factor to underperform in the near future since, far from being unanimous about the reasons of its pertinence, literature mainly explains such a low risk anomaly by behavioural (that is persistent) bias, along with other theories referring to the interaction of delegated portfolios, benchmarking to market capitalization benchmarks, and the fund managers’ utility function (in other words, referring to the structure and the functioning of capital markets). On the other hand, we believe that the low risk factor is not the only relevant Smart beta performance driver. The chart below shows the factors that mainly contributed Amundi Conservative equities outperformance, during 2015

Finally, Smart Beta strategies typically invest in low-correlated and diversifying stocks. Because of their diversifying features, their fair required rate of returns should be lower than what is implied in capitalization weighted indices (that only reflect the size of companies’ business), and their fair price should consequently be higher than their current price. Smart beta strategies ultimately benefit from this kind of price adjustment that takes place when investors recognize such a superior risk efficiency. We believe that such a re-pricing is far from over, since investors are still massively invested in market capitalization indices, and since recent inflows to market weighted products still correspond to the vast majority of the inflows towards the broad equity market

Melchior Dechelette
Head of Active Smart Beta Strategies

Alessandro Russo
Head of Equity Quantitative Research

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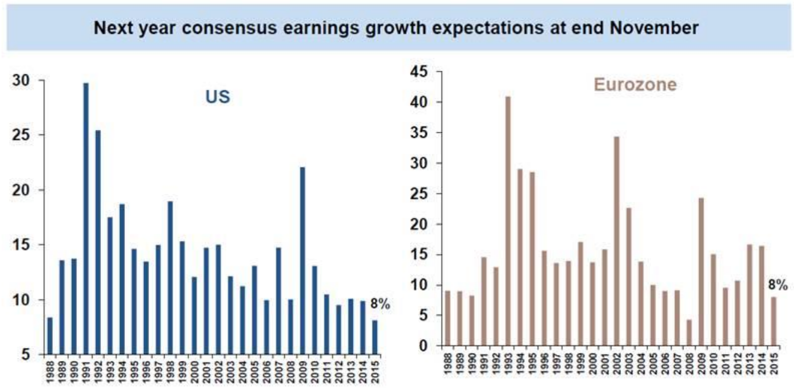
Earnings: starting the year on a more realistic note

Analyst expectations for 2016 are very conservative



Consensus earnings growth expectations	2014	2015	2016	2017
US	5%	0%	8%	13%
Eurozone	3%	11%	8%	11%

Source: Société Générale

For several years now we have been noting a regular trend in analyst consensus estimates. We begin each year with very optimistic (most often double digit) earnings growth expectations, which are then revised downwards in the course of the year as analysts are confronted with soft growth figures. 2016 could be different. As illustrated by the chart, which shows consensus estimates compiled each November for the year ahead, starting from 1988, expectations for this year are very conservative in both the US and the Euro zone. More specifically, in the US we have to go back to 1988 to find such a degree of caution. This observation also applies to the Euro zone, because the end 2008 consensus was factoring in the impact of the subprime crisis. This is for us an important factor to underline, because it means that market upside in 2016 need not depend on an expansion of multiples that would be more significant than the downtrend in consensus expectations. In other words, a headwind would disappear in 2016 in a context where we may see an acceleration of economic growth in the Euro zone.

The close to 30% decline in commodity prices in 2015 explains to a large extent the disappointments in earnings expectations (according to Amundi 2015 EPS growth was down 40% and 62% respectively in Energy and Metals and Mining in December 2015 compared to -12% and +5% expected in January 2015). Excluding resource sectors, EPS growth in 2015 would have been 11%, i.e. close to the January 2015 estimates. We do not expect a rebound in underlying commodity prices in 2016 (oil expected to stay under $45), which leads us to remain cautious on resource-related sectors in the short term (but with a clear preference for Energy relative to Metals and Mining), especially as the consensus appears to us to be still too optimistic in its projections for 2016, notably for Metals and Mining. At the same time, the ongoing slide in commodity prices should continue to benefit sectors exposed to consumption and to domestic demand (increase in household purchasing power) which were already among the best performers in 2015. It should be noted that, contrary to the consensus, Amundi does not expect any additional contribution of resource-related sectors to 2016 EPS growth (+9% both including and ex-resource sectors), which reassures us about the "realistic" nature of our projections for this year.

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Head of Equity Research

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