Confidence must be earned

Amundi ASSET MANAGEMENT

# CROSS ASSET

## INVESTMENT STRATEGY

## CIO VIEWS

### SENTIMENT REBOUND FAVOURS ROTATION TOWARDS VALUE

## THIS MONTH'S TOPIC

### CORPORATE FUNDAMENTALS ARE AT THE CENTRE OF THE GAME

Research & Macro Strategy

# CIO VIEWS

## Sentiment rebound favours rotation towards value

PASCAL BLANQUÉ, Group Chief Investment Officer
VINCENT MORTIER, Deputy Group Chief Investment Officer

In recent weeks equities rallied along with bond yields as investors reacted to the prospect of a US-China 'phase one deal' and fading global recession fears. The value of negative yielding bonds continued to fall, from US$17 trillion over the summer to the current US$12.5 trillion. While equities were previously overshadowed by the excessive gloominess on the global economy and earnings, markets rebounded after corporate results in the US and Europe met or exceeded low expectations, and as economic data did not show any material worsening. The mantra now seems to be **'not so bad is the new good'**.

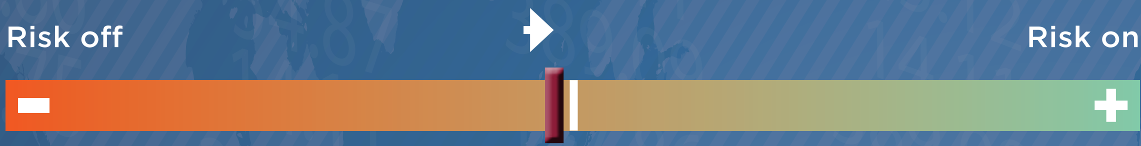
On the economic front, the picture is mixed, **but some stabilisation is in sight**. The manufacturing outlook remains weak in developed markets (DM), however resilient emerging markets (EM) growth is supporting the global economy. The service sector has been robust almost everywhere and we don't see any major concern on the US consumer front, the main engine of US growth. In our previous editions, we highlighted our view that global recession fears were overdone and we maintain that stance. From a geopolitical perspective, the situation is tricky in many parts of the world, such as Latin America and Hong Kong, but **there is good news in Europe,** where the risk of a no-deal Brexit has receded. **Investor sentiment is finally turning more positive for Europe after very difficult years.**

Overall, the following **themes will play out for investors going into 2020**:

- **Fixed income investors will have to deal with opposing forces on the direction of interest rates**. Central Banks are restoring some sort of QE. This could limit the potential upside in bond yields. On the other hand, there is already fiscal policy noise in the market and this will continue to grow next year. This could put upward pressure on rates, which will likely start pricing a "fiscal option". Given these diverging forces, we could see a stabilisation in rates, with some possible short-lived overshooting. As a result, **active and flexible duration management** is important. In credit, an easing environment could give rise to asset price bubbles and may push investors to illiquid/low quality assets in their search for yield. Investors should be mindful of highly indebted companies and speculative sections of the market. A focus on balance sheet strength, bottom up selection and liquidity risk will be crucial.
- **A stabilisation of interest rates could also affect stock prices** as additional support from lower yields fades. If earnings growth remains flattish, we would not expect to see a material upside in stock prices; instead a **rotation of themes in equities could provide compelling opportunities**. Growth stocks have dominated value stocks and the ratio of growth versus value has reached excessive levels. A stabilisation of rates could drive a rotation in favour of value. Beaten-up sectors such as EU banks and autos may also benefit. **Europe would gain from this rotation as it is predominantly a value market.**
- **Finally, another area of opportunity for investors will be emerging markets.** Accommodative monetary policies, due to expanding Fed balance sheet and the ballooning US fiscal deficit, point to a weaker dollar. This would be good news for EM debt and currencies in 2020. Some stabilisation in earnings, amid a rebound in economic growth, would also benefit selective EM equities.

As we approach year-end, the situation is better than it was in the summer, with a persistence of the bull market in risk assets. We continue to believe that the probability of a consumer-led recession is low but investors should aim to preserve this year's performance. However, markets have already priced in most of the good news, and would need something else for the bullish sentiment to strengthen further. In the short term, investors should play this renewed sentiment improvement, **especially in Europe and EM**, but also prepare for a more tricky phase in which markets will take a sanity check of global economic conditions**. The main risks, in our view, will not come from the economic side, but from deteriorating fundamentals in some pockets of the credit market, which could potentially trigger a sell-off.** Investors should bear in mind that in this cycle credit spreads are more sensitive to a miss in economic growth targets given the high liquidity risks.

## Overall risk sentiment




Cautious stance continues, but mild improvement in risky assets expected.

## Changes vs previous month

- Become more constructive on equity (move to neutral on equity with cross-asset perspective)
- Favour sector rotation to value globally

Overall risk sentiment is a qualitative view of the overall risk assessment of the most recent global investment committee.

# MACRO

## When political risk crosses the Atlantic

DIDIER BOROWSKI, Head of Macroeconomic Research
MONICA DEFEND, Global Head of Research

At the beginning of 2019, all eyes were focused on Europe, not only because of the risk of a Hard Brexit, but also because of the open crisis between the Italian government and the European Commission. The situation has changed radically since this summer.

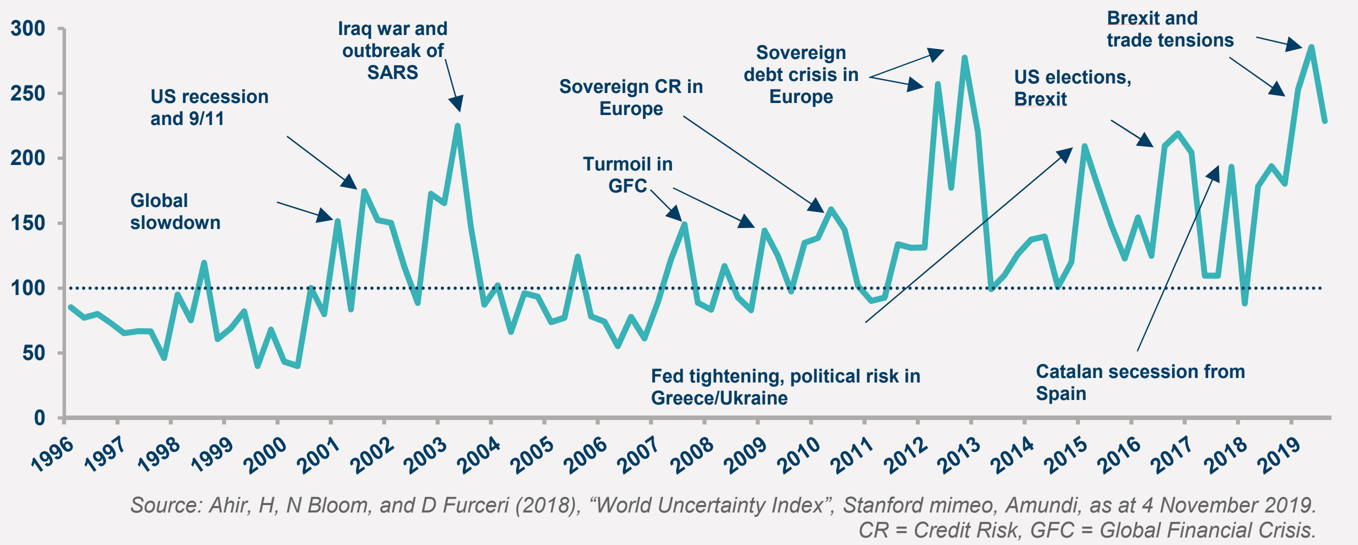
**On the UK side**, whatever the outcome of the elections (12 December), **it seems clear that a Hard Brexit is no longer on the agenda**. If the Tories win, they will vote for the plan negotiated by Boris Johnson. And if the Labour Party wins, Jeremy Corbyn will probably try to challenge Brexit through a referendum. Ultimately, the British economy is moving towards a long transition period; once the plan is accepted, negotiations with the EU will begin. These negotiations will likely prove long and difficult, but the systemic risk of leaping into the unknown is no longer a danger. **In Italy**, the change of coalition during the summer completely changed the approach in terms of economic policy, with a more European orientation than in the past. This does not change the medium-term fragility of Italy from a macrofinancial standpoint (high public debt, very low potential growth), but the new government coalition was very well received by investors. The fall in interest rates gives a breath of fresh air to the country and the financial system as a whole.

> "Political risks will likely shift from Europe to the US ahead of the 2020 Presidential elections, leading to volatility in markets."

**The EU will therefore be able to refocus on a more normal political agenda.** With new leadership at the helm of key institutions (Ursula von der Leyen at the head of the European Commission and Christine Lagarde at the head of the ECB), the theme of the financial architecture of the Eurozone (capital markets union, banking union) will undoubtedly come back to the fore. From investors' point of view, this is good news, especially compared with the fears at the beginning of the year. In addition, from an economic point of view, **the Eurozone as a whole appears to be rather resilient in the face of the global trade shock.**

On the other hand, the **US is entering a period of uncertainty in 2020**. The election campaign has started de facto, in a very tense climate due to the impeachment procedure launched by the Democrats. Even if it has very little chance of succeeding (the Republican majority Senate will reject the procedure), it is making

### World uncertainty index




*Source: Ahir, H, N Bloom, and D Furceri (2018), "World Uncertainty Index", Stanford mimeo, Amundi, as at 4 November 2019. CR = Credit Risk, GFC = Global Financial Crisis.*

a lot of noise and there could still be surprises in store. At the same time, Democratic candidates are very actively preparing for the primaries. These are not classic primaries. "Centrist" candidates (Biden, Buttigieg and Bloomberg) oppose "radical/social-democratic" candidates (Warren, Sanders). **This is the first time that such radical political proposals have been defended within the Democratic Party by a candidate who has a real chance of winning the primaries.** Strikingly, as of today, the fundraising of radical candidates far outweighs that of centrist candidates. In addition, Senator Warren has a solid popular base in a few key states and she is progressing in the polls.

**The "super Tuesday" (3 March 2020) will be a key date for the primaries.** The battle promises to be close in the Democratic camp with fundamental issues at stake (dismantling of big techs, energy policy, regulation, foreign policy). At the end of the day, those investors who now seem convinced that Trump will easily win the elections may have to reconsider their position. This could be a source of volatility in markets.

# MULTI-ASSET

## Portfolio balance in absence of market directionality

MATTEO GERMANO, Head of Multi-Asset

Global economic conditions remain weak, despite some small improvements. We expect developed markets will decelerate in 2020, while emerging markets will remain resilient and widen the growth gap with advanced economies in the second part of next year. The inflation outlook is benign, with temporary upside risks being contained and mainly linked to the impact of tariffs and some job shortages in the US. As the long-term impact of "unconventional" monetary policies is still largely unknown, further monetary easing on its own could become counterproductive. Although we believe there is some room for manoeuver on the fiscal side given the low level of rates, investor expectations of a favourable fiscal and monetary policy combination are overdone in the short-term, unless a major trigger (such as a recession or financial crisis) materialises.

### High conviction ideas

Due to the aforementioned conditions, we believe it is **too risky to take a strong directional view on equities.** We prefer to adopt a **neutral stance**, until we have more clarity on the trade front and a confirmation of economic stabilisation. We remain positive on US duration but we are wary of upside risks to yields as the recession fears fade. We believe the following **four themes** will underpin multi-asset investing in the near future:

1. **Caution and flexibility are key in equities**, for which we see single-digit earnings growth next year. Our view is more conservative with respect to the markets because we believe unit labour costs are on an upward trend and capex growth is anaemic. This should limit the market's upside. On the other hand, a continuation of the bull run and a rotation of themes cannot be ruled out due to improving geopolitical sentiment. Accordingly, we have recently become less negative on Europe and the US.
2. **Secondly**, optimism on positive developments on trade and Brexit appears to be priced into the market: **the recent sell-off in core bonds may well be temporary**. We maintain a constructive outlook on US 5y versus Germany 5y and US 10y outright.
3. **Thirdly**, **continued monetary easing by central banks supports the outlook for spread products.** We like both EUR IG and HY, but prefer EUR over US as European markets are more supported by technical factors (flows and the ECB). The **search for yield** continues, particularly in Italy where the 30y BTP is one of the few instruments with attractive positive yields. However, the recent increase in political risk (pressure on the government on domestic front) must be watched.
4. **EM assets provide diversification in a cross-asset portfolio.** EM bond yields are appealing, relatively speaking, as they provide attractive carry and as dovish EM central banks support the environment. Investors should

> "Economic conditions remain weak but could rebound next year, leading to a less negative on US and European equities in the short term."

remain positive on EM bonds (HC), but keep in place adequate hedges for duration and FX risks. **In EM equities**, we have a neutral view and remain selective. On a positive note, we like Korea, China A-shares and other domestic consumption-focused themes. We are slightly less constructive now on GEM FX given the recent rally. Some positive developments in the trade disputes drove short-term risk-on sentiment for EM currencies, but our medium-term view of an ongoing trade war has not changed.

### Risks and hedging

US-China trade talks (and Hong Kong escalation), geopolitical risks around Brexit (UK elections on 12 December) and Iran-related issues still have the potential to bring some volatility back into the market. Therefore, we recommend investors maintain hedges in the form of JPY/USD and gold, which could help safeguard portfolios in case of a sudden downturn.

**Amundi Cross Asset Convictions**

| | 1 month change | --- | -- | - | 0 | + | ++ | +++ |
|---|---|---|---|---|---|---|---|---|
| Equities | ↗ | | | | ■ | | | |
| Credit | | | | | | | ■ | |
| Duration | | | | | | ■ | | |
| Oil | | | | | ■ | | | |
| Gold | | | | | | ■ | | |
| Euro cash | | | | □ | | | | |
| USD cash | | | | | | ■ | | |

The table 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.

# FIXED INCOME

## Credit remains the key engine of returns

ERIC BRARD, Head of Fixed Income
YERLAN SYZDYKOV, Global Head of Emerging Markets
KENNETH J. TAUBES, CIO of US Investment Management

We are witnessing a stabilisation in global growth supported by the positive news flow around consumption and geopolitical issues such as the trade war and Brexit. **However, these issues have not completely vanished**, and could bring some volatility back to the market as activity is fading as we close in on year-end. Supportive technicals and continued monetary easing (although the easing cycle could lose momentum) offer a favourable environment to exploit carry. It is not yet time to **be conservative in credit**, but investors should continue to focus on liquidity and selection and be mindful of any signs of further economic slowdown.

### DM bonds

In global fixed income, while keeping a **neutral overall view on duration**, we continue to **prefer** the **US to Europe** (more negative on Germany) and Japan, and we are less positive on duration in the UK. The Bank of England (BoE) will now wait for the elections and Brexit before taking any action on rates. Accordingly, we believe the UK curve steepening will not happen. **In the EU**, we keep our flattening position in place. We maintain a positive view on the main peripheral European countries as the QE programme has restarted, but have adjusted our view in both Italy (more constructive) and Portugal (less positive), while favouring long dated bonds in Spain. The search for yield continues in US and EUR IG (should benefit from QE) but we are slightly more positive on the US than before. The EUR HY space is also attractive, unlike US HY, but we remain watchful for any idiosyncratic risks**. In the US**, the yield curve has finally steepened amid solid US employment and consumer spending data. The Fed may test markets by seeing how strong the economy can become and how low unemployment can go before igniting inflation expectations. The FOMC feels that the cuts taken this year are sufficient and therefore additional rate cuts are unlikely. At the same time, given the FOMC's willingness to allow inflation to overshoot its target, rate hikes also seem implausible.

**In US credit**, we prefer to play upon sector rotation and security selection across a broad range of sectors. Specifically, we like consumer-oriented sectors such as structured securities, including both agency and non-agency RMBS. These assets are less exposed to a risk of economic downturn and are spurred by a strong US consumer sector and lower mortgage rates. On the corporate side, while valuations are a bit expensive, the default outlook remains benign and fundamentals are relatively stable. Here, we advise watching leverage levels for IG corporates.

> “The US yield curve has steepened amid solid employment and consumer spending data, supporting our view that markets are underpricing inflation expectations.”

## EM bonds

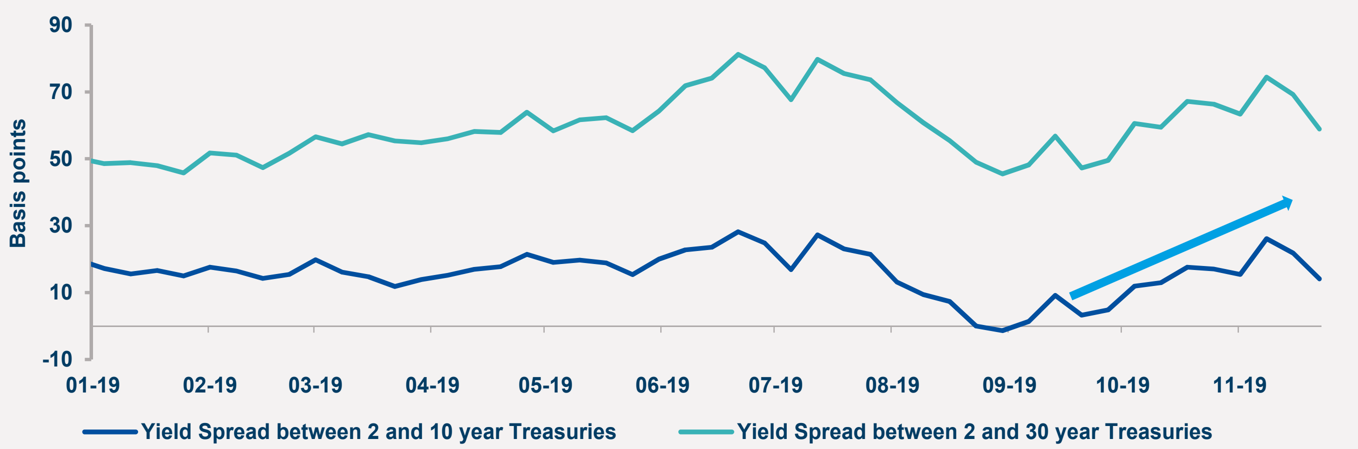
**We maintain a constructive view on hard currency debt** as valuations and technicals both look strong. We prefer HY credits as spreads have lagged their IG counterparts. EM local rates also look attractive, although we are slightly more cautious given the strong performance YTD and less compelling valuations. We are less negative on EM FX, given the slight improvement in the global growth outlook, prospects of a trade deal, and the Fed's balance sheet expansion. But EM FX remains for the time being our least preferred asset class given its sensitivity to global growth.

## FX

We have a neutral view on the US dollar: arguments that the USD could have peaked are appearing (i.e. fiscal deficit). In Europe, we are constructive on NOK vs SEK, given the Norges Bank's hawkish stance, and neutral on the GBP

*QE = Quantitative easing, FOMC = Federal Open Market Committee, EM FX = Emerging markets foreign exchange, YTD = Year-to-date, IG = Investment grade, HY = High yield, JPY = Japanese yen. GBP = British Pound, RMBS = Residential Mortgage backed Securities, NOK = Norwegian krone, SEK = Swedish krona.*

### US yield curve steepening




*Source: Bloomberg, Amundi as of 18 November 2019*

EQUITY

# Time for 'value' investing is ripe

KASPER ELMGREEN, Head of Equities
YERLAN SYZDYKOV, Head of Emerging Markets
KENNETH J. TAUBES, CIO of US Investment management

## Overall assessment

The reducing risk of a no-deal Brexit and the progress on US-China trade talks have supported equity prices over the past month. European equity is the favoured market at the moment as tail risks have reduced and economic indicators may start stabilising, although at low levels. However, if trade tensions escalate, US equities could offer better risk-adjusted returns. Globally, the disconnect between growth vs. value should offer opportunities due to extremely depressed valuations in the latter. We believe that a **rotation to value will be the key theme for equity investors in 2020**. This rotation could also benefit Japanese equities, given their strong fundamentals. Income from equity dividend will also be key, in a world of ultra-low interest rates**.**

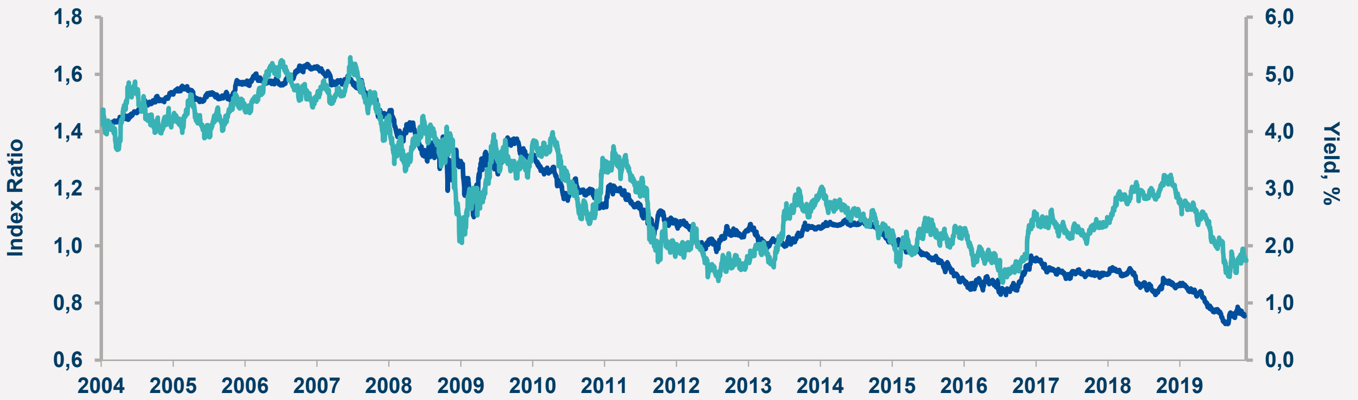
"Rotation from the expensive areas of growth to cheap value stocks could provide opportunities, supported by a reversal in bond yields and progress on a trade deal."

## DM equities

After material outflows from EU equities, we are finally seeing some inflows. As market positioning is very light, there is still some room to see investor sentiment improving towards this asset class. Overall returns are likely to be lower than in the past (due to a "normal" market multiple and lower economic growth) and with high volatility, but the sentiment seems finally turning in favour of Europe.

In particular, **market rotation** from the expensive areas of 'growth' to cheap 'value' stocks could provide investment opportunities. **A reversal in bond yields and an improvement in the trade war situation would support this rotation**. Cyclicals vs. industrials also looks attractive, due to low implied expectations. From a sector perspective, health care and telecoms provide some degree of protection while bond proxies such as utilities and consumer staples remain expensive. Finally, innovation and business model disruption will drive returns in areas including media, automotive, business services and retail. **In the US, earnings were better than feared, leading the S&P 500 to reach new highs.** Consensus expectations for

### Yields bottoming out should support value in Europe




Source: Bloomberg, Amundi as of 18 November 2019

2020 are too optimistic and modest downward revisions should not pose major risks. However, indicators for earnings are improving, driven by strong top-line growth and manageable wage inflation. **At a style level**, now is a **good time for value vs. momentum**/low beta stocks as the former could benefit from any reacceleration in the economy and improving fundamentals. The **cyclical part of value is also attractively priced.** In addition, opportunities exist in growth, particularly on the technology side. On the other hand, we believe, low-beta sectors such as utilities have excessive valuations and very low free cash flow yields. We are positive on communication services, financials and consumer discretionary, but are cautious towards energy and information technology.

## EM equities

**In EMs, we are moderately more constructive on equities** in light of expectations of a more stable economic growth in the region in 2020, the continuation of global monetary easing by central banks and some optimism about a trade deal. On top of that, EM equity valuations remain attractive vs. developed markets and the technical backdrop is supportive of the asset class. Nevertheless, downside is still possible given the risks surrounding global geopolitics, and therefore we expect volatility to persist. We **prefer domestic consumption countries** (Brazil, Indonesia, Russia and India) and stay defensively positioned on countries where there is political noise.

**Amundi asset class views**

| | Asset Class | View | 1M change | Rationale |
|---|---|---|---|---|
| EQUITY PLATFORM | **US** | = | | The US equity market has been a core holding in this cycle, supported by stronger earnings growth than elsewhere. While in short term there is some ambiguity about earnings, we expect revisions to turn positive in the medium term. This, coupled with positive liquidity and low interest rates, could support the equities market as long as the trade war does not intensify. |
| EQUITY PLATFORM | **Europe** | =/+ | | Europe has suffered during this cycle from below potential profits, high international exposure and political risks, however, these negative factors are fading as the probability of a Brexit deal increases. Should a bottoming out of global manufacturing materialise, Europe will benefit more than others. A shift to value would also be positive. |
| EQUITY PLATFORM | **Japan** | = | ▲ | Japan has experienced ups and downs in this cycle and was among the worst performers until August 2019. Earnings growth has been lower than the rest of the world since 2016, and this should be the case again next year. However, Japan could benefit from a shift to value and its low valuations. |
| EQUITY PLATFORM | **Emerging markets** | = | ▲ | Earnings revisions are bottoming out and we expect good opportunities for investors in emerging markets in light of strong domestic consumption-related stories and favourable monetary and fiscal policy. We remain constructive on China A-shares. However, idiosyncratic issues (Latin America, Brazil, Turkey) are the key risks. |
| FIXED INCOME PLATFORM | **US govies** | =/+ | | We maintain our preference for US Treasuries duration vs. other developed markets, on better absolute and relative valuations and the Fed having more leeway at its disposal on conventional tools |
| FIXED INCOME PLATFORM | **US IG Corporate** | =/+ | | Dovish central banks and favourable technical are overall supportive of the US credit market, although not to the same extent as EUR IG (CSPP and negative rates are a European peculiarity). However, given lingering macro uncertainties, we prefer to keep a cautious attitude on credit risk, favouring high quality carry and increasing the focus on liquidity assessment. |
| FIXED INCOME PLATFORM | **US HY Corporate** | = | | Valuations of US HY spreads look tighter than in other credit segments and we prefer high quality over lower rated names due to more idiosyncratic risks and rising default risks, together with liquidity reasons. Sector selection remains key, as distress looks concentrated in a few sectors. |
| FIXED INCOME PLATFORM | **European govies** | -/= | | We remain constructive on the main peripheral European countries such as Italy (more positive) and Spain, fuelled by ECB action, a new political pro-European coalition in Italy and the ongoing search for yield. Curves are expected to flatten on the back of persisting yield hunting. |
| FIXED INCOME PLATFORM | **Euro IG Corporate** | ++ | | We are positive on Euro IG, particularly on BBB-rated debt and financials. Strong technicals are here to stay, for example ECB's new net purchases and higher corporate sector purchase programme reinvestments, which provide steady positive investment inflows into the asset class and intensify yield hunting. However, liquidity conditions in secondary must be monitored. |

| | Amundi asset class views | | | |
|---|---|---|---|---|
| | Asset Class | View | 1M change | Rationale |
| FIXED INCOME P. | **Euro HY Corporate** | + | | Technicals are favourable in this asset class where we prefer high quality and more liquid BB-rated debt on the back of the attractive risk reward combination and given higher downside risks to the macro picture. But we focus on selection, idiosyncratic risks and liquidity. |
| FIXED INCOME P. | **EM Bonds HC** | + | | EM bonds could be a natural candidate in the current environment of low yields and global monetary policy easing. The EM-DM GDP growth gap is expected to widen further in favour of EM. |
| FIXED INCOME P. | **EM Bonds LC** | = | | In the short term we maintain a neutral view, while on a 12 month horizon the outlook is more constructive. Local rates have fallen and we don't see triggers for a continuation of this trends. EM FX will remain volatile, but we believe that the pessimism is overdone. Should trade disputes ease and the global manufacturing sector bottom out, this would lead to a weaker USD |
| OTHER | **Commodities** | | | Commodity and precious metal prices should be supported by easing financial conditions, decent economic growth and CBs' active management of balance sheets. As a result, we remain constructive on gold (hedge against geopolitical risks). For oil, we reiterate our target range of \$55-\$65 for WTI and \$60-\$70 for Brent, while acknowledging that risks are skewed to the downside due to the cooling global oil demand and sluggish Chinese growth. Long term, US oil production and OPEC strategy will driver oil prices. Elsewhere, we are positive on base metals as we think the manufacturing sector could stabilise. |
| OTHER | **Currencies** | | | We expect the USD to trade lower on a 12M horizon due to US fiscal stimulus, US-China trade dispute resolution and a potential intervention by the Fed/US Treasury. The upside on EUR/USD will be limited, given the slowdown in Europe, political risks and rates differential between US and Europe. The 12M target for GBP/USD is increased slightly to 1.31 amid receding concerns of a no-deal Brexit but the target for USD/JPY is kept at 104 (supported by uncertain global growth). We are neutral on EM FX and believe the CNY would move in the range of 7.10 to 7.20 |

**LEGEND**

| --- | -- | - | = | + | ++ | +++ | ▼ | ▲ |
|---|---|---|---|---|---|---|---|---|
| | Negative | | Neutral | | Positive | | Downgrade vs previous month | Upgraded vs previous month |

Source: Amundi, as of 20 November 2019, views relative to a EUR-based investor. 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.

IG = Investment grade corporate bonds, HY = High Yield Corporate; EM Bonds HC / LC = EM bonds hard currency / local currency. WTI= West Texas Intermediate.

# THIS MONTH'S TOPIC

## Corporate fundamentals are at the centre of the game

VALENTINE AINOUZ, CFA, Fixed Income and Credit Strategist

Finalised on 3/12/2019

### The essential

**Over the last decade, easy financial conditions encouraged an increase in sovereign and corporate debt.** Indeed, the leverage of American companies has reached record high levels and US corporate debt has been used for financial risk-taking to fund corporate payments to investors, as well as for mergers and acquisitions. At the opposite, the leverage of European companies has remained at low levels as European companies have remained more cautious over this cycle. In 2019, we have evolved in a new regime: the global economy has entered a synchronised slowdown and major central banks have returned to an easing stance. What are the risks for companies in this new context? **We are following closely:**

- **The downgrade risk in the US Investment Grade universe.** Net leverage for US issuers have resumed their upward trajectory in recent months. In 2020: (1) companies to make a trade-off between maintaining share buy backs and the stability or their debt (2) the downgrade risk to increase among firms facing increase pressure on profits.
- **The default rate risk for low-quality high-yield bonds**. Sluggish earning growth poses the biggest threat for companies to pay interest on their debt despite the low cost of financing. Indeed, at this stage of the cycle, we think that interest coverage is more closely related to earnings than to its interest expense: interest coverage could be quickly eroded by a hit to earnings. A selective approach is required in the low-rated Euro and US High Yield segments.

**Central bankers have been the main player in town for the last decade.** They have done a great job regarding financial stability but they failed to significantly stimulate investment spending and to bring inflation back to 2%. At the same time, easy financial conditions encouraged an increase in sovereign and corporate debt. Indeed, corporate debt has risen, and has been used for financial risk-taking to fund corporate payments to investors, as well as for mergers and acquisitions, particularly in the United States. **In this note, we will assess the risk of corporate debt while we have evolved into a new regime:**

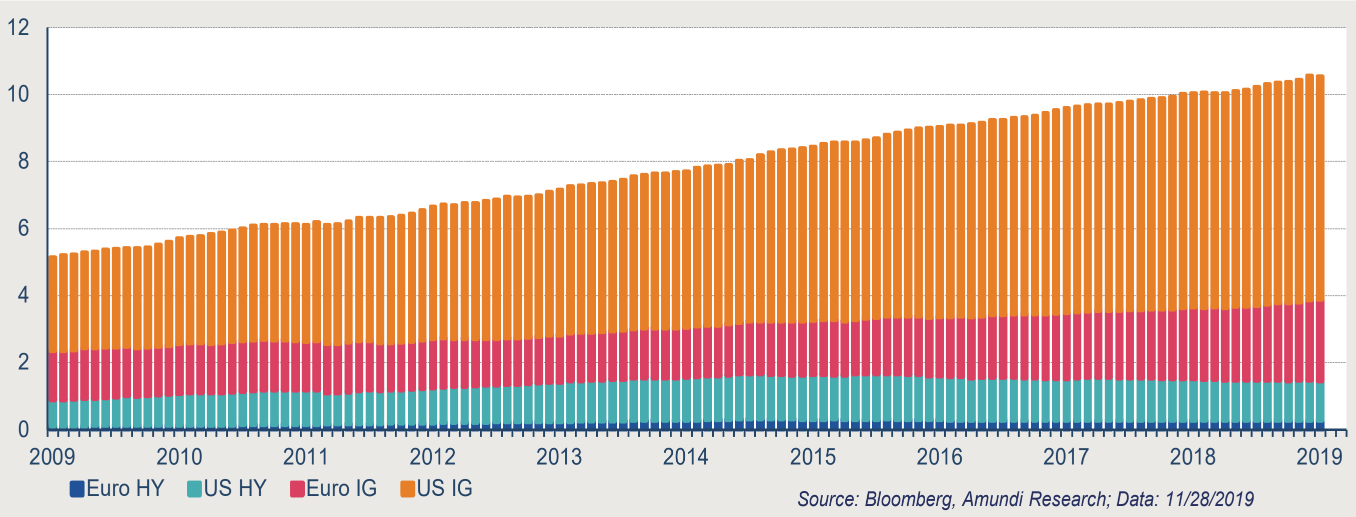
- **The global economy has entered a synchronised slowdown** after a synchronised pick-up in 2017. Momentum in manufacturing activity has weakened substantially, to levels not seen since the financial crisis, on the back of rising trade and geopolitical tensions, the slowdown of the Chinese economy and a slump in the auto industry. This year will see growth at its lowest rate since the beginning of the decade and the IMF expects slower growth in nearly 90 percent of the world.
- **The world's major central banks have returned to an easing stance this year** due to muted inflation and lower global growth expectations. Most of the major central banks have lowered borrowing costs in recent months and have restarted asset purchase programmes.
- **Political risks are expected to remain high with the upcoming US and UK elections.**

### This cycle was marked by a sharp increase in corporate debt

**According to McKinsey, global non-financial corporate debt, including bonds and loans, more than doubled over the past decade, growing by $37 trillion to reach $66 trillion in mid-2017**. The institute also estimates that nearly 20 percent of total global corporate debt is in the form of bonds, almost double the figure in 2007. In total, over the decade, the size of the global non-financial corporate debt market increased by (source: OECD):

- 70% in advanced economies from USD 5.97 trillion in 2008 to USD 10.17 trillion in 2018. The US IG market has increased from around $2.2 trillion to $6.7 trillion.
- 395% in emerging markets, mainly driven by growth in China, to reach a total outstanding amount of USD 2.78 trillion in 2018.

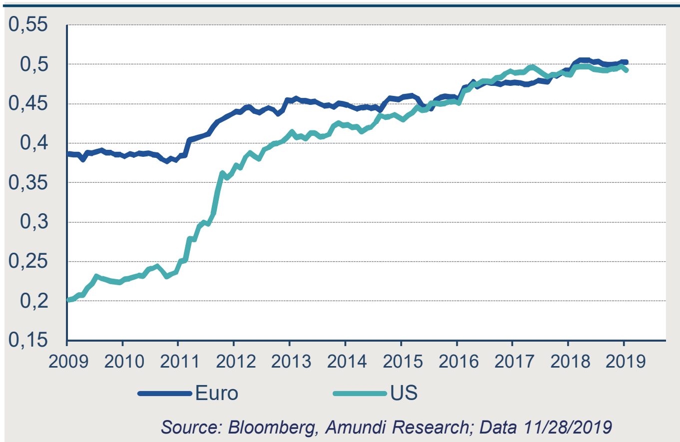
## 1/ The size of the corporate bond market (in trillion $, face value)



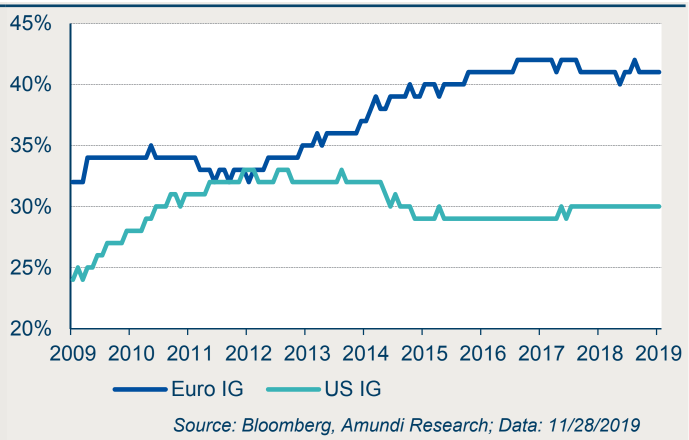

**The growth in the size of the corporate debt market has been accompanied by a steady decline in overall credit quality both in Europe and the US**. BBB-rated debt now accounts for around half of the whole investment grade market. However, explanatory factors between the two zones are different.

- The expansion of the BBB segment in Euro IG could be explained by a substantial increase in the number of issuers: (1) corporate bond issuance provided an alternative to deleveraging banks and (2) many US issuers tapped the euro corporate bond market.
- In the US market, the deterioration in overall credit quality could also be explained by the increase in the leverage of American non-financial companies.

## 2/ The share of investment Grade market rated BBB



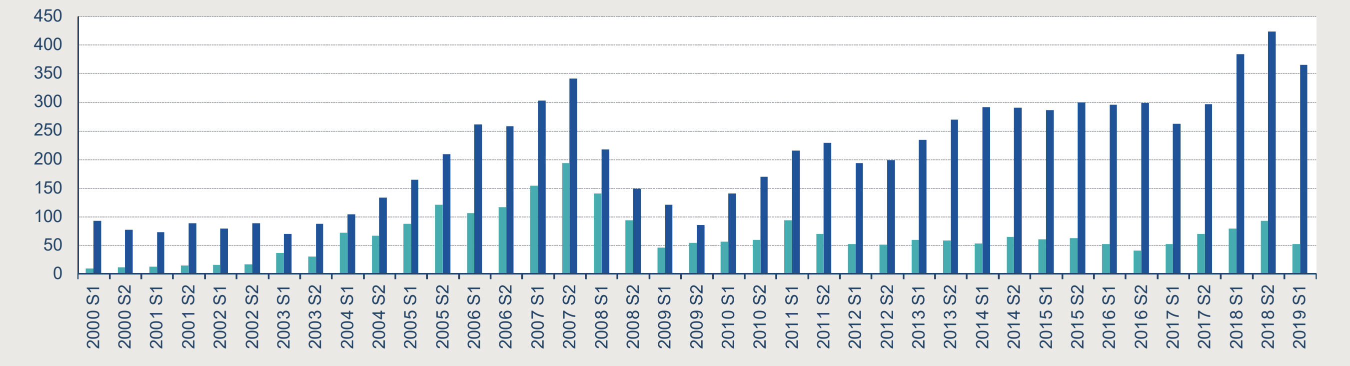

## 3/ The share of investment Grade market issued by foreign issuers




**Indeed, the balance sheet of American and European companies has followed different trends over the past decade:**

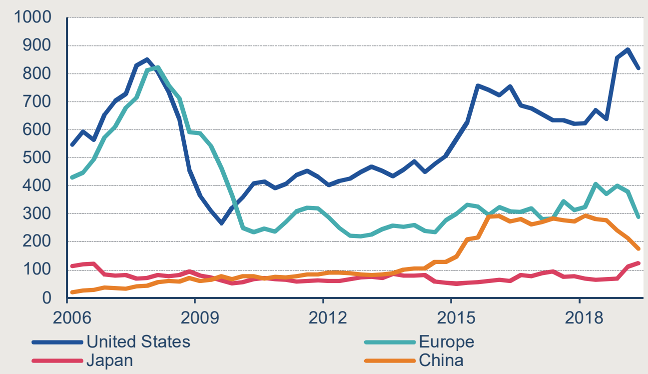
- **The leverage of American companies has reached record high levels.** American companies have raised huge amounts of cash on financial markets to fund record numbers of mergers and acquisitions and share buyback activities. Back in 2010, only 10% of the IG non-financial market had net leverage greater than 4.0x, but as of 2017, that share increased to 20%.
- **The leverage of European companies has remained at low levels, as European companies have remained in a cash preservation mode over this cycle.** Less than 12% of the IG non-financial market has net leverage greater than 4.0x and this share declines to 5% if we exclude the Utilities and Energy sectors.

### 4/ Share buyback activity (in $bn)



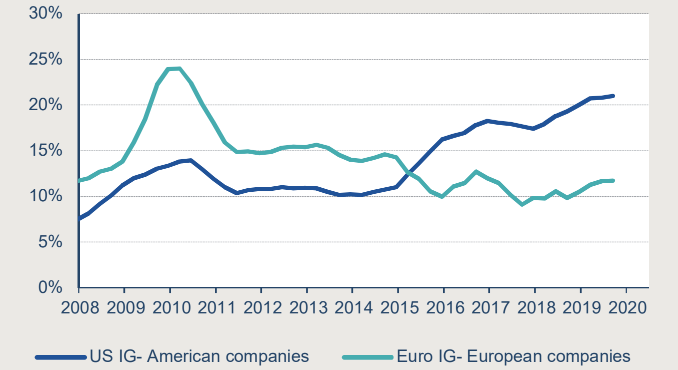

Source: Bloomberg, Amundi Research; Data: 11/28/2019

### 5/ Global Mergers and Acquisitions Deals (in $bn)




Source: Bloomberg, Amundi Research; Data: 11/28/2019

### 6/ % of issuers recording a leverage above 4 (4q ma)




Source: Bloomberg, Amundi Research; Data: 11/28/2019

## What are the recent trends in corporate fundamentals and what are the risks?

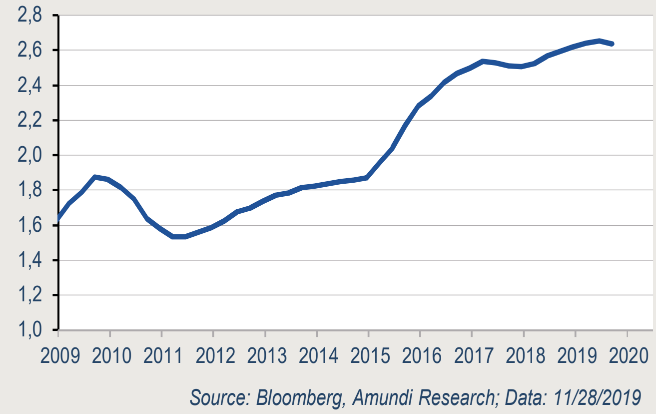
After a sharp deterioration in recent quarters, global growth is expected to come out at 3% for 2019. The weakness in growth is driven by a deterioration in manufacturing activity and global trade, with higher tariffs and prolonged trade policy uncertainty damaging investment and demand for capital goods. At corporate levels, these trends have resulted in a slowdown in sales and capex growth for a majority of issuers. Indeed, capex growth correlates closely with revenue and profitability trends. The decline was more pronounced in the energy, utilities, materials and industrial sectors. At the same time, the easing trend of most central banks has supported the search for yield and investors' appetite for credit. Euro and US Investment Grade credit experienced strong activity in the primary market and corporate borrowing remained high for most companies. Let's take a segmented look at the latest changes and challenges ahead.

### 1. US Investment Grade: companies were once again leveraging up in Q3

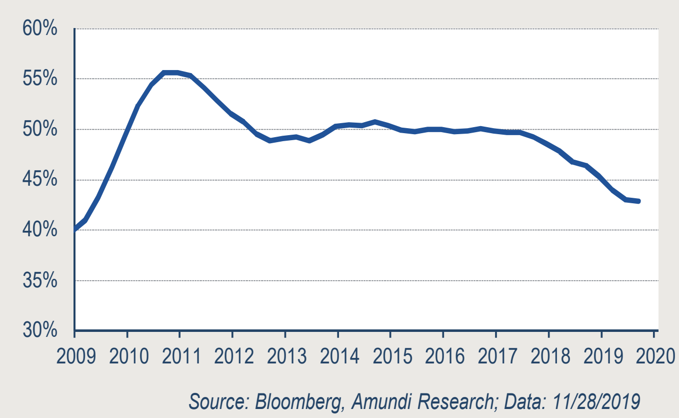
- **Net leverage: reached an all-time high in Q3** and we did not see much evidence of broad-based deleveraging across the US IG universe. Indeed, 66% of the companies in our universe even increased their leverage ratio in Q3 2019 vs. Q3 2018.
  - # Companies continued to raise debt to support M&A and share buybacks. S&P 500 companies are on track to buy back another $800bn of stock in 2019, according to JP Morgan, down slightly from around $830bn in 2018. Companies are now returning more cash to shareholders than they are generating in free cash flows.
  - # However, many US companies are moderating their capital expenditure spending. Some companies have warned that this could continue this year as US elections are likely to add uncertainty to decision-making.
- **Interest Coverage ratio: declined in recent quarters** but it remained in a bright spot thanks to the record low cost of funding.
- **Cash ratio: declined to its lowest level since 2010**. The recent decline has coincided with a sharp increase in leverage. The cash ratio declined across most sectors in recent quarters.

**Our convictions: our greatest concern on the US IG segment is the high level of leverage**. Unless earnings growth accelerates, companies will have to make a trade-off between maintaining share buybacks and the stability of their debt. Moreover, the risk at this stage of the cycle is a change in the story. During this cycle, the rise in the leverage of American companies was mainly driven by debt growth. In the future, the increase in indebtedness could also be the result of a slowdown in earnings growth.

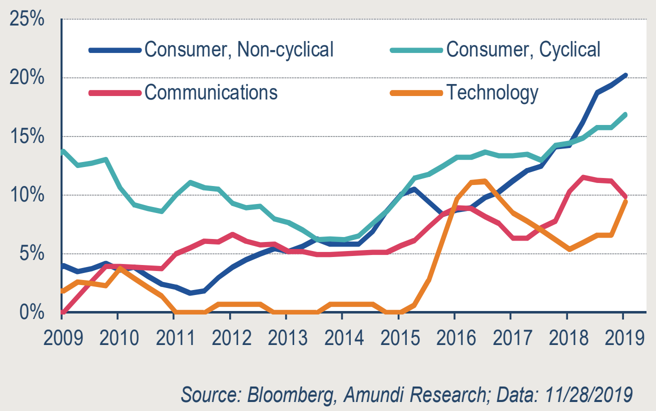
### 7/ US IG Net debt to EBITDA (4q ma)



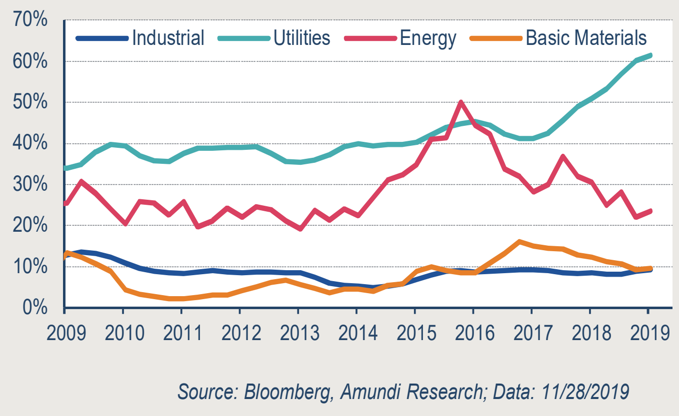

### 8/ US IG Cash ratio (4q ma)




### 9/ US IG % of issuers recording a leverage above 4 (4q ma)




### 10/ US IG % of issuers recording a leverage above 4 (4q ma)

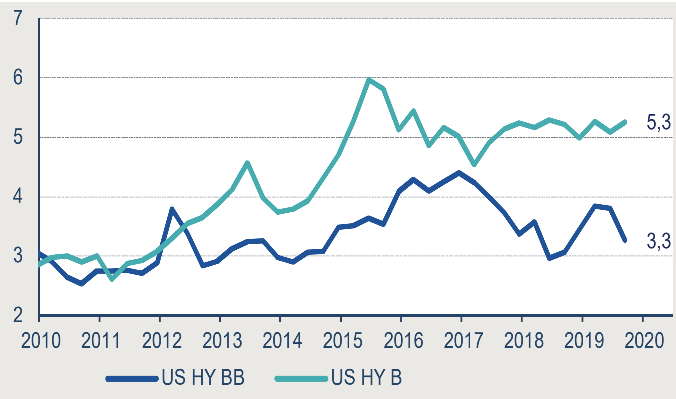



## 2. US High Yield: stabilisation in recent quarters but high level of vulnerability for B and C rated issuers

- **Net leverage: stabilised at high levels.** US HY issuers were focused on balance sheet improvement over the past two years and stabilised/reduced their leverage. It should be noted that the dynamics were asymmetrical between different rating classes. The fundamentals of BB-rated issuers have improved while debt levels remain particularly high for issuers rated B and C.
- **Interest coverage ratio: deteriorated over the last few quarters due to lower earnings growth**. The sharp rise in the number of challenged firms is concentrated in B and C rated bonds. Currently, 32% of High Yield firms appear unable to meet interest expenses out of earnings. The situation is more concerning for low-rated issuers (B and C). We have no serious concern on the BB segment.
- **Cash ratio: decline to its lowest level since 2010.**

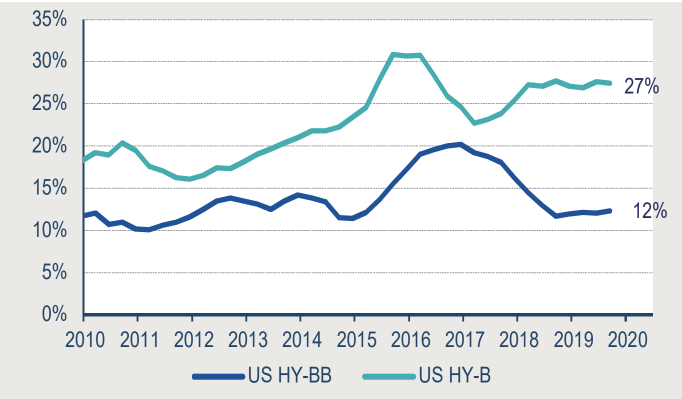
**Our convictions: our biggest concern in the US HY segment is that defaults could begin to rise as firms have more difficulties to pay interest on their debt**. Given how late we are in the cycle, we think that interest coverage is more closely related to earnings than it is to interest expense: interest coverage could be quickly eroded by a hit to earnings. The IMF has also warned that the number of firms with very low interest coverage ratios is already high and sees the number of firms with very low interest coverage ratios as a common signal of distress. The IMF highlights that the risk is more concentrated on small companies.

11/ **US HY Net debt to EBITDA**



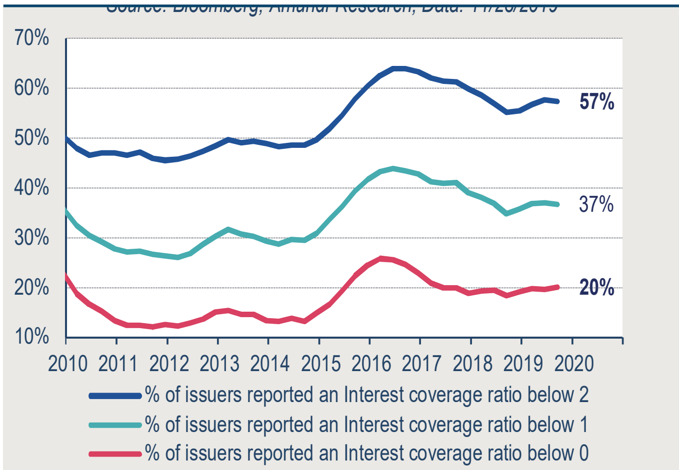

*Source: Bloomberg, Amundi Research; Data: 11/28/2019*

12/ **US HY % of issuers reported a Leverage above 6**



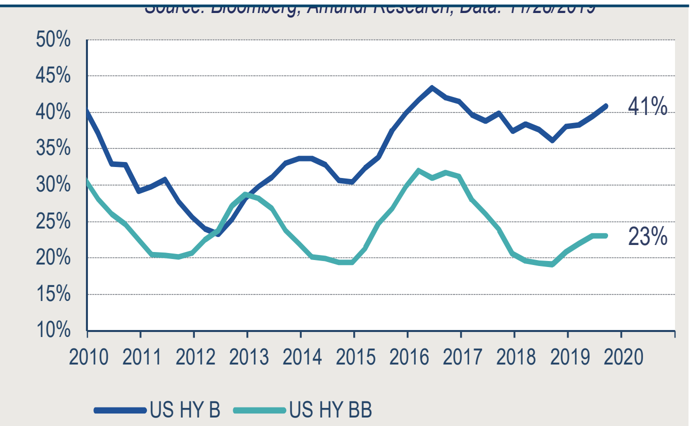

*Source: Bloomberg, Amundi Research; Data: 11/28/2019*

13/ **US HY Interest coverage ratio**




*Source: Bloomberg, Amundi Research; Data: 11/28/2019*

14/ **US HY % of Zombie issuers***



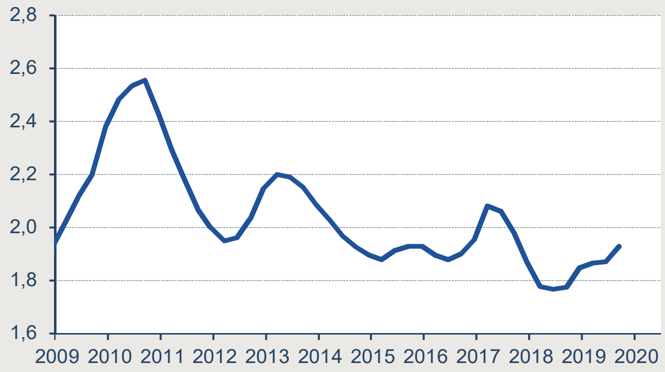

**with an Interest Coverage ratio below 1*
*Source: Bloomberg, Amundi Research; Data: 11/28/2019*

## 3. Euro Investment Grade: slight deterioration in Q3 but fundamentals remained relatively stable

- **Net leverage: deteriorated slightly in Q3 but has remained relatively stable since the financial crisis**. Over the cycle, European companies have remained in a cash preservation mode. The pace of debt growth has accelerated so far this year, but from very low levels. This is in line with the stronger activity recorded on the Euro IG primary market. Capex also increased over the last few quarters, from the muted levels recorded over the cycle.
- **Interest Coverage ratio: fell in recent quarters but remained in a bright spot** due to the record low cost of funding and low level of debt.
- **Cash ratio: declined to its lowest level since 2010.** The recent decline in cash balances has coincided with a slight increase in leverage.

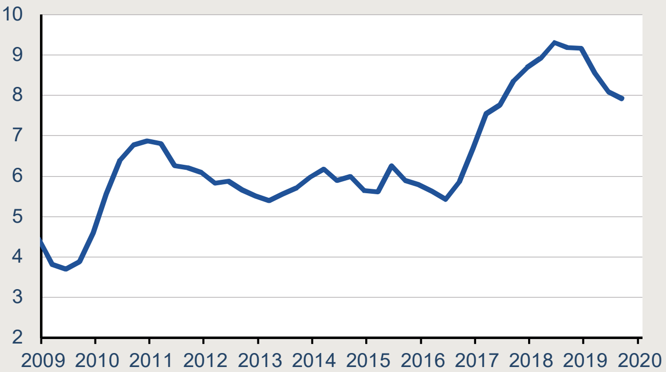
**Our convictions: We have no major concerns about the fundamentals of European investment grade companies.** There is still no evidence of broad based re-leveraging. However, at this stage of the cycle, the weak profit growth picture is a limiting factor in improving the balance sheet of European companies.

15/ **Euro IG Net debt to EBITDA (4q ma)**




*Source: Bloomberg, Amundi Research; Data:11/28/2019*

16/ **Euro IG Interest coverage ratio (4q ma)**



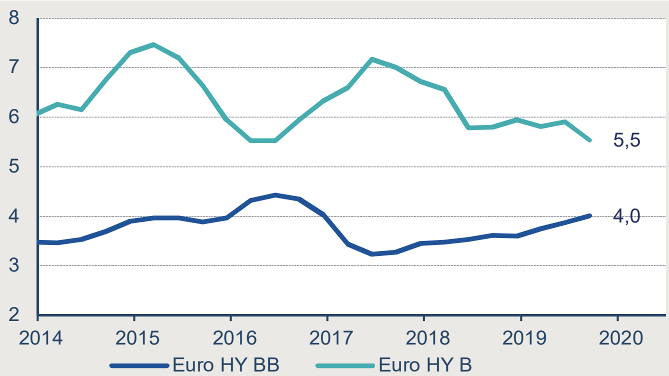

*Source: Bloomberg, Amundi Research Data: 11/28/2019*

## 4. Euro HY: stable picture for BB but higher level of vulnerability for B and C

- **Net leverage:** stabilized at high level for B. Credit metrics remained relatively solid for BB.
- **Interest coverage ratio:** slight deterioration in recent quarters especially for low rated issuers.
- **Cash ratio:** slight deterioration in recent quarters.

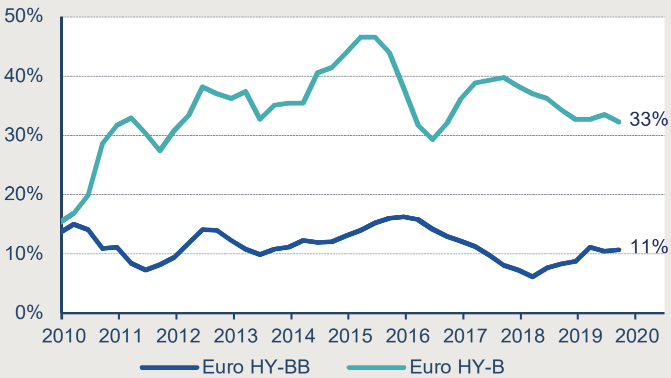
**Our convictions:** as for US HY, our main concern is the debt service capacity for low-rated issuers. There is no significant difference in terms of credit metrics between Euro and US HY. However, the HY structure is more defensive in Europe than in the US. BB account for 71% of Euro HY versus only 50% of US HY.

17/ **Euro HY Net debt to EBITDA**




*Source: Bloomberg, Amundi Research; Data 11/28/2019*

18/ **% of issuers with a Leverage above 6**




*Source: Bloomberg, Amundi Research; Data 11/28/2019*

## Financing conditions remain favourable due to strong support from easing monetary policy

**There is no maturity wall.** The corporate bond market has benefited from the “hunt for yield,” with rates on government debt securities at or near all-time lows – and even below zero in many places such as Europe and Japan. Strong demand for credit coupled with strong activity on the primary market enabled companies to refinance their debt and extend their maturity profile.

**However, the level of refinancing needs has significantly increased in recent years.** Given the size of the current outstanding stock of corporate bonds, companies, especially in the US, are facing record levels of repayment requirements in the coming years. As of December 2018, companies in the US need to pay or refinance USD 2.9 trillion within 3 years.

## We maintain an up-in-quality bias. Selective pick-up in B.

The stabilisation in the macro backdrop coupled with strong technical support will likely prolong the cycle for higher quality issuers. However, risks remain skewed to the downside and the outlook for weaker credit quality remains challenging in our view. We think 2020 will continue to test the most growth-sensitive segment as earnings are unlikely to experience a strong rebound. We maintain an up-in-quality bias with a selective pick-up in B for valuation reasons. We see a sustained decline in earnings as the main risk factor.

# Risk factors

Macroeconomic Research Team

**The table below presents risk factors with judgmental probabilities (i.e. not market based). It also develops the possible market impacts.**

Finalised on 27/11/2019

| Risk # 1 | 20% probability | Major European slowdown |
|---|---|---|

**Analysis | Germany escaped the risk of a technical recession in Q3, posting meagre, yet positive, 0.1% quarterly growth.** The French economy turned in a positive surprise in the third quarter, with +0.3% growth, the same pace as in the two previous quarters, while the Italian economy was unchanged again, at 0.1%. Spain's growth was also quite strong at 0.4%, somewhat dissipating concerns of a faster-than-expected deceleration. Preliminary data on business surveys, which in the past months have pointed to a worrying deterioration of the manufacturing sector and to the risk of contagion to the service sector, have sent out a mixed picture, with manufacturing somewhat better-off but the service sector slightly deteriorating in aggregate. The main risk at this point is that the manufacturing recession will weaken the economy further and spread to services. Many factors could aggravate the situation, particularly a new escalation in Sino-US tensions (European manufacturing is heavily exposed through its global value chains), additional US duties on the European auto sector (which have been postponed for now), and Brexit (for which uncertainty remains, although the probability of a no-deal Brexit has receded significantly). The roll-out of fiscal measures (which we envisage for now to take place at the national level) could help stabilise domestic demand amidst external uncertainties, but there seems to be little appetite for a coordinated EU effort. Against this backdrop, a significant upturn in growth in 2020 is unlikely, and risks are weighted to the downside. Moreover, in most euro zone economies the job market is still a key factor in support of household consumption and monitoring signs of deceleration is of great importance.

**Market impact |** A major slowdown would clearly be bad news for European assets and the euro. But in this case, the policy mix would become even more accommodative, in both monetary and fiscal terms, and that would help stabilise growth expectations. Any negative market impact (from a more serious-than-expected slowdown) is therefore likely to be of short duration, as investors would hurry to price in the policy mix's positive impact on the economy.

| Risk # 2 | 20% probability | US recession |
|---|---|---|

**Analysis |** The US economy is gradually slowing: growth peaked in Q2 2018 and, since then, the US economy has been gradually decelerating towards potential. Incoming data support the view that domestic demand is gradually slowing due to weakening investments and a labour market shifting into lower gear. Looking forward, we expect muted growth in investments and diminishing US consumer spending, although we do not expect any recession. Some indicators would point to a stabilization in manufacturing and therefore limited impact on the service sector, yet coincident indicators are flashing the risk of having below-par growth in Q4. Uncertainty on the trade front and persistent geopolitical issues represent key risks to our outlook, which remains tilted to the downside.

**Market impact |** The markets are likely to become more circumspect with regard to 2020 growth expectations, as deceleration could become more pronounced and as signals point to slower domestic demand. In this context, the Federal Reserve will keep attempting to facilitate a macroeconomic soft landing by countering the forces that could drag down US growth, and we expect a protracted dovish bias.

Risk # **3** | **15%** probability | **US & China: negotiations resume**

**Analysis |** The truce announced in October, based on more purchases by China of US agricultural products and no increase in tariffs by the US is still missing relevant details, and in the meantime the bar to achieving the Phase One Deal has been raised by China's asking for the rollback of the tariffs currently in place. Once the Phase One Deal is signed, a phase two should start. Since the recent talks, the two sides have been sticking to a more constructive tone. In mid-November, the General Temporary Licences for US companies to operate with Huawei were extended by 90 days with no further developments. The risk remains sizeable because we have to bear in mind that the confrontation with China goes far beyond the Republicans. Regardless of who is elected US President next year, opposition between the two countries on strategic issues could worsen their relations in the coming years. It is therefore important not to misunderstand the context. Protectionist rhetoric will not disappear from the radar screens. The likelihood of a comprehensive agreement is very low.

**Market impact |** Along with the tit-for-tat approach, the most relevant impact on the markets following recent events has been the CNY depreciation above the psychological threshold of 7 against the USD. The trade-weighted dollar is now historically high, and EM currencies had a short period of instability in the aftermath of the CNY depreciation. That instability is likely to grow in the event that the CNY depreciates much further.

Risk # **4** | **15%** probability | **Major geopolitical crisis in the Middle-East**

**Analysis |** Although there are always geopolitical risks in the Middle East, tensions between the United States and Iran have escalated this year after Donald Trump: 1/ cancelled exemptions that allowed some countries to import Iranian oil, and 2/ introduced new sanctions against Iran. Security incidents and aggressive statements from both sides have only worsened matters. However, the US President is unlikely to want to embark on an armed conflict with Iran, the consequences of which could be far-reaching, less than a year before the next US presidential election. Although the situation remains volatile and despite the large number of complex fronts in the Middle East, recent White House decisions (withdrawal of US forces from the border between Syria and Turkey) do not point towards an increased US military presence in the region. Moreover, there seem to be new indirect peace talks between Saudi Arabia and the pro-Iranian Yemeni Houthi rebels.

**Market impact |** Oil prices are the main thing to watch, while open confrontation between the United States and Iran could be detrimental to the most risky asset classes and could trigger a rise in safe-haven investments in the dollar. However, at this stage we are not expecting a major upsurge in oil prices, given the high level of US shale gas production and statements by Saudi Arabia and the UAE to the effect that they would make up any reduction in Iranian exports.

Risk # **5** | **15%** probability | **Political instability in Italy with renewed stress on BTP**

**Analysis |** The Draft Budgetary plan has been submitted. The political situation remains challenging as the coalition stability may be undermined by local election results in January, where opposition parties seem to have the lead in polls; disputes within the government coalition are showing its fragility. Despite the sharp reduction in near-term risks relating to a potential debt crisis or a long-lasting political confrontation with the European authorities, structural issues, which are a medium-term concern (including the public debt burden and limited fiscal space), remain unresolved. In the meantime, the League seems willing to position itself differently in relation to the European theme. Its leader has recently shown a different attitude toward the euro and Europe in general. Over the past week he has publicly indicated that he could favour Draghi as the next president of Italy; that Giorgetti (a less divisive political figure) could be the next finance minister; and that the League doesn't intend to leave the euro. The League was instrumental three weeks ago in the approval of the French candidate to the European Commission (by abstaining instead of voting against), showing a more "constructive" attitude; it is also looking to enter one of the government coalition parties in the European Parliament, which would be something to watch.

**Market impact |** Italian financial markets welcomed the avoidance of further uncertainties that would have been inevitable in the event of a snap election. As a result, BTP vs. Bund spreads tightened strongly. A small premium for political risks is likely to remain priced in, given the latent fragility of the coalition and approaching local elections. Some volatility and widening may be possible due to short-term tactical positioning; yet overall, there is still room for yields to decline, especially at the longer end of the curve.

| Risk # **6** | **10%** probability | **Major political crisis in Europe** |
|---|---|---|

**Analysis |** Although European elections offered a small "pro-institution" surprise (instead of the wave of Euroscepticism that had been forecast), the European Parliament is more fragmented, and European institutions and governments have been entangled in a phase of negotiations that is more protracted than usual for appointments to key EU posts (European Commission, Council, Parliament and ECB). And at the national level, political complexity seems to be increasing, with difficulties in forming governments (e.g., Spain), instability of existing governments (e.g. Italy), and increased fragmentation, which could point to future complexity, especially in the negotiations for increased integration at EU level. We believe this is unlikely to trigger a major crisis on the European level, but there is no guarantee that voter support for "anti-system' parties has peaked, and, in the near term, the presence of these parties in national parliaments is making it harder to establish government majorities. Policy-making is therefore becoming less predictable, particularly in major countries where that had previously not been the case (such as Germany and Spain).

**Market impact |** As the political landscape remains complex at the national and supranational levels, the difficulty that foreign investors have in understanding European institutions will not vanish easily, which means that European assets will continue to price in a specific political risk premium.

| Risk # **7** | **10%** probability | **Major slowdown in the "emerging world"** |
|---|---|---|

**Analysis |** The recent trade war escalation has caused growth to slow once again in the EM universe and elsewhere. However, growing dovishness on the part of the main central banks (namely the Federal Reserve and the ECB) is making the global financial environment easier for emerging markets. A more pronounced USD depreciation is the missing factor. The rosier financial picture will only worsen if there is any abrupt reassessment in the very dovish Fed/ECB monetary policy stance. Having said that, the amount of dovishness announced and realistically put through should prevent idiosyncratic risks from becoming systemic, as happened in Argentina in August. In the real economy, spillover from the external demand shock to domestic demand (mainly via capex) has been considerable in Asia, more so than in other regions. In order to see the expected stabilisation in growth and not a major slowdown, an orderly solution to the trade dispute (Phase One signed at least) is needed sooner rather than later.

**Market impact |** In the risk case, spreads and equity markets would once again be significantly impacted. This is particularly true as emerging currencies would once again be under pressure from capital outflows. However, emerging markets are far from being a homogeneous block, and the markets would worsen more in the countries that are the weakest and most vulnerable due to their poor external positions or fragile fiscal and political conditions.

| Risk # **8** | **10%** probability | **A Chinese "hard landing"/ a bursting of the credit bubble** |
|---|---|---|

**Analysis |** Chinese economic growth is slowing down, but the authorities are working hard to keep the on the path of manageable slowdown path (through monetary and fiscal policies). Recent data indicate that the trade war is biting and a more supportive policy mix is required. The country's economic model is fragile, as signs of excessive credit are visible, and non-financial corporate debt has surged since the GFC. The good news is that the NFC debt-to-GDP ratio had been declining since late 2017 (although it has lately increased slightly). We will continue to monitor the trend in Chinese private debt closely, especially if the economy slows. If a harder landing looks likely, the Chinese authorities still have enough ammunition to offset the shocks, including more depreciation, an expansion of credit in the property market, and more expansionary fiscal and monetary policy.

**Market impact |** A hard landing triggered by a bursting of the credit bubble would have a very negative impact, and its cascading effects would be particularly disastrous, including vulnerability of banking systems (in China and elsewhere), vulnerability of the global financial system, vulnerability linked to China's public and private debt, a negative impact on regional and global trade, and thus on commodities and emerging countries, impacts on the currencies of commodity-exporting countries, advanced and emerging economies, and so on.

Risk # **9** | **5%** probability | **No-deal Brexit**

**Analysis |** The UK government and the EU reached a new Brexit agreement on 17 October. The UK parliament approved the agreement in principle but refused to ratify it in a fast-track procedure. This refusal obliged the British prime minister to request and obtain an extension to the Brexit deadline to 31 January 2020. Whatever the outcome of the 12 December elections (the Conservative Party is currently clearly ahead in opinion polls), the risk of no-deal Brexit is low. Victory for the Conservatives will probably be followed by ratification of the 17 October agreement o, and therefore an orderly Brexit in January 2020. A win by the opposition parties could lead to a second referendum and the possibility that the UK will remain in the EU (though the outcome of such a referendum remains highly uncertain). A no-deal Brexit would now require a combination of problematic events (for example, failure to form a majority government after the general election, a new compulsion to renegotiate the agreement with the EU, or a rejection by voters of the choices put to them in a referendum) and the failure to find any other solution to avoid a hard exit. Yet there remains uncertainty concerning the future UK-EU trade relationship, which will have to be negotiated during the transition period (this period will follow Brexit and maintain UK access to the EU single market, yet it may end as soon as December 2020, hence the possibility of a new "Brexit cliff" risk one year from now if no comprehensive free trade agreement has been signed).

**Market impact |** The risk of no-deal has fallen sharply, justifying a contraction in the risk premium on UK assets and a rise in Sterling. However, it is important to remember that the Brexit process is far from being over and that there could be new periods of stress if markets fear that the UK could abruptly lose its access to the EU single market at the end of 2020.

# MACROECONOMIC CONTEXT

## Our convictions and our scenarios

Macroeconomic Research Team

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

### CENTRAL SCENARIO (55% PROBABILITY): Resilient domestic demand and services despite uncertainty adversely affecting trade

- **Slower global growth:** the economic weakness seen worldwide during the summer has continued into the fall with very few exceptions. Industrial surveys and data continue to show that the global manufacturing sector is in recession. However, domestic demand remains more resilient, due primarily to household consumption, which continues to be buoyed by very low inflation and in certain economies by strong labour markets. Still, services have proved more resilient than manufacturing.

- **Global trade expected to bottom out in H1 2020:** global trade has plummeted over the past 18 months, due to protectionist rhetoric. Even assuming that: (1) the Phase-One deal between China and the US is signed sooner than later, and (2) the next round of tariffs planned by mid-December is delayed while remaining part of an ongoing negotiation, we believe the damage to world trade dynamics at this point is done. We expect global trade to recover very slowly in 2020. Indeed, global trade is expected to remain under pressure in the short run and to grow at a slower pace than global GDP next year. Note that the impact on economies differs from one region to another. European exports are being hit strongly by generally weak intra-EU demand and declining ex-EU demand for intermediate and capital goods (Italy and Germany). The US is advancing steadily on the path of import substitution (imports of industrial supplies and materials have decreased from 27% in 2007 to 18% out of total imports in 2019). EMs are trying to transform the challenges posed by trade tensions into opportunities. Taiwan is one of the economies in Asia benefitting the most from the trade diversion from China to the US, and it has been the only EM economy, among the ones covered, that is seeing its growth performance upgraded during 2019. In addition, we must not underestimate the resilience of domestic demand at the global level. While global trade has indeed made a strong contribution to global growth over the last few decades, this is less and less so, as global growth is now being driven primarily by domestic demand.

- **United States:** a gradual return to potential, with slightly greater downside risks. The US economy, boosted by very accommodative fiscal policy in 2018, began decelerating in H2 2018 and continued to do so in the following quarters. After peaking at 3.2% YoY in Q2 2018, GDP growth gradually slowed to 2.0% YoY in Q3 2019. Fixed investments have been trending down markedly since the second half of 2019, while personal consumption expenditures have remained resilient overall. Protracted weakness in global trade and manufacturing, coupled with uncertainty over the implementation of tariffs, may have played a role in discouraging investments, partially offsetting the benefits of fiscal policy. Corporate and consumer confidence have indeed worsened and only recently stabilised somewhat. Signals are starting to appear that the labour market is decelerating, supporting the view that domestic demand will keep slowing into 2020. Risks remain tilted to the downside: although a truce on the trade front may be reached, geopolitical tensions will persist and political uncertainty may be added to the framework as the presidential elections approach. Although we do not expect a recession to occur, doubts on the extension of the current cycle could intensify over the next few quarters (with less support from fiscal policy, and domestic demand decelerating). The Federal Reserve is expected to stick to its dovish bias, signalling reasonable pragmatism and cautiousness in using its "policy ammunition", yet continuing to check financial conditions (mainly driven by the USD's trade weighted strength).

- **Eurozone:** The Eurozone economy remains under pressure, as uncertainty continues to characterize the global economy. The Eurozone has seen a deterioration in external demand and the manufacturing sector has been hit severely, questioning whether spillovers into services and other important economic sectors were materializing. However, despite the persistence of major uncertainty hotbeds globally, expectations on economic fundamentals have progressively turned towards a more constructive outlook. Accordingly, the Eurozone economy is expected to stabilize heading towards 2020 and 2021 as the manufacturing sector is potentially bottoming out, clustering expectations for a very gradual and mild recovery, supported also by a more constructive global trade outlook. Moreover, the labor market is sound in aggregate terms, the unemployment rate remains low, and wage growth is moderate. Household consumption should be the main driver of growth in Eurozone, playing a pivotal role in shaping its way along the recovery process. Conversely, signals of expansionary fiscal policies remain limited to country-level implementation but have not taken shape so far as a coordinated effort. A further push remains theoretically possible in particular should the economy worsen and struggle to rebound.

- **United Kingdom:** The UK government reached a new Brexit agreement with the EU in October. However, ratification by the UK Parliament could not be secured in time to avoid another extension of the Brexit deadline from October 31, 2019 to January 31, 2020. Before this new deadline, a general election will take place in the UK on December 12. Polls currently give a strong advantage to the Tories. Should they win a majority, a ratification of the October agreement, and thus an orderly Brexit in January, would become by far the most probable scenario. A victory by opposition parties, on the other hand, would open the door either to a softer deal or to a new Brexit referendum. Thus, there remain only residual paths to a hard Brexit, which would require a sequence of problematic events (for instance, another hung Parliament and the failure of any alternative solution to resolve the continuing Brexit gridlock that would follow). Note, however, that even after an orderly Brexit, there would remain many uncertainties regarding the future UK-EU trade relationship, including the possibility of another Brexit "cliff" risk if the transition period is not extended and if the UK loses its access to the EU single market at the end of 2020.

- **China:** October's string of data confirmed the weak economic conditions, with further deterioration since the previous months. At this point, we confirm our view of a GDP decelerating at the range floor of 6% YoY in H2 2019 (Q3 GDP released at 6% as expected) and below 6% YoY in 2020 (at 5.8% YoY). Chinese authorities have signalled their difficulty to keep real growth above 6% YoY. Again, the latest data haven't shown a uniformly gloomy picture. Property sector and some components of industrial production have been resilient, while infrastructure investments have continued to decelerate in the private sector and managed to stabilize in the public sector. The authorities have ramped up their stimulus very mildly to accommodate the deceleration mentioned above in particular on the monetary policy side (with cuts in MLF and LPR in November). Credit growth has very mildly decreased again, driven by RMB loans and local government generic and special bonds. China's surplus with the US is narrowing on the back of marginally higher Imports (as agreed in the Phase One deal) and weaker and weaker exports.

- **Inflation:** core inflation is still moderate in the US and very low in the Eurozone, despite continued improvements in labour markets. While the causes of this "lowflation" may not be entirely understood, many explanations have been proposed. First, there is a problem with the quality of many of the jobs that have been created in the current cycle (low-paid and/or part time jobs), with employees not in a position of strength to obtain wage increases. Second, structural changes in goods and services markets (new technologies in trade, in particular, and, more generally, the "uberization" of the economy) may also have a disinflationary impact. In addition, after years of very low inflation, inflation expectations are low, which can be a self-fulfilling prophecy. Lastly, in the Eurozone, recent reforms (to the labour market and goods and services markets) have created a more competitive environment. Despite these hindrances, and while the growth cycle has not come to an end, we still believe that inflation should rise, driven by wage rises. However, the increase will be very gradual and the ECB's target ("below, but close to, 2%") seems out of reach for the time being.

- **Oil prices:** Despite idiosyncratic risks and geopolitical tensions in the Middle East, global demand, US oil production and OPEC strategy will be the key drivers for 2020. Uncertainty over global demand abounds for several good reasons. The trade war escalation has exacerbated downside risks to the overall economic picture slowdown, while China's transition to a new economic growth model and GDP deceleration is weighing on global oil demand. On top of that, US oil production has proven very resilient and oil seems less vulnerable than in the past to supply disruption concerns. Recent events in the Middle East (Iran's oil exports slide after US sanctions and the attack on Aramco production) did not structurally affect energy prices. Crude oil looks less sensitive to geopolitical risks, due to the unprecedented jump in US production. The US has steadily become a net exporter this year, eroding a significant OPEC production share. Therefore, US shale oil production will remain the long-term crucial factor and will affect OPEC decisions in 2020. We maintain our target range of $55-$65 for WTI and $60-$70 for Brent, even if we acknowledge the risks are skewed to the downside due to global oil demand cooling and sluggish Chinese growth.

- **Central banks:** back to a “wait and see” attitude in AEs. As expected, the Fed lowered the fed funds rate to 1.5-1.75% for the third consecutive time at the October FOMC. This decision was taken in response to continued uncertainty about the trade war and the global manufacturing recession, in a context where inflation remains low. President Powell basically said that the current monetary policy stance was now appropriate given the moderate growth outlook, which means that the Fed's decisions will depend on the data. We expect the Fed to cut its key rates further by 25bp over the next 12 months, slightly more than currently priced-in by markets. The bottom of the cycle has not yet been reached, which will probably keep the Fed under pressure next year. A pause is widely expected in December given recent positive trade news (an agreement between the US and China seems to be about to be concluded). In addition, we expect the Fed to continue to manage its balance sheet very actively. For the ECB, the situation is quite different. There have been strong disagreements on the restart of the QE and Christine Lagarde will have to rebuild a broad consensus. We expect little additional accommodations unless some downside risks materialise. We however continue to expect a final rate cut (-10 bp to -0.6%) by mid-2020 due to (1) subpar growth, (2) inflation that is consistently below the ECB's target and (3) downside risks.

## DOWNSIDE RISK SCENARIO (30%): full-blown contagion to domestic demand

**Two “families” of risks with different conclusions on monetary policies and scenarios**

1. **Trade-related risks:** global trade takes longer to “normalise”, additional escalation in the trade war, and full-blown contagion into consumption:
   - **Growth falls further, profit recession /** the global recession comes back to the forefront
   - **Central banks:** even more accommodative monetary policies than what are currently priced in by markets
   - **Fiscal policies:** would gradually take over from monetary policy to support growth
2. **Market-related risks:** sudden repricing of risk premia with a large impact on financial conditions, exacerbated by low liquidity (various triggers: wars (e.g., the Middle East), the crisis in HK, credit event (HY) etc.)
   - **The policy mix** (fiscal & monetary) would become much more proactive (i.e. pre-emptive) in that case, while it would likely come somewhat later with trade tensions alone.

## UPSIDE RISK SCENARIO (15%): modest reacceleration of global growth in 2020

- We have revised down our growth forecasts substantially since the start of the summer by embedding part of the downside risk scenario into the central scenario. By definition, this means that it’s now much easier to be “positively surprised”. For instance, on the political level the most recent news flow is more positive (with a pro-European coalition in Italy, a possible trade de-escalation, and a hard Brexit scenario that has become highly unlikely).
- Subsequently, going forward, we may see at the same time lower (political) risks and a more expansionist policy mix worldwide, which would pave the way for a rebound in confidence and a quicker normalisation of global trade.
- A modest reacceleration of growth (slightly above potential) – vs. subpar growth in the base case – is a distinct possibility.

# **Macroeconomic picture** by area

Macroeconomic Research Team

Finalised on 2/12/2019

## United States

### US growth gliding along, supported by monetary policy

- Domestic demand keep slowing, with investment spending hit worse than private consumption. Business climate surveys have worsened over the past few months but have recently shown signs of a tentative bottoming-out.
- Consumer confidence indicators are mixed, on average suggesting that US households are less upbeat about the future. With softer gains in both payrolls and salaries, consumption should moderate and post an average year. On the investment front, spending plans are slowing. Inflation remains low (1.8% headline and 2.3% for core inflation); core PCE (1.7% YoY) remains close to, but below, the Federal Reserve's target.
- The Fed flagged that it considers its policy stance appropriate and well calibrated to support moderate growth and resilience on the labour market, and that another cut would require a "material reassessment of the economic outlook". Yet, as we expect some disappointment to come on growth, we are still pencilling another cut for H1 2020.

**Risk factors**

- While a mini-deal with China is in sight, uncertainty remains high; past uncertainty has already impacted the real economy in part.
- A mid-December step-up in tariffs has not been ruled out yet. If implemented, it might impact U.S. domestic demand more extensively
- Geopolitical risks and tariffs could pose an upside risk to oil prices and to our inflation outlook

## Eurozone

### Some improvement

- Q3 GDP growth (+0.2% qoq) was slightly better than forecast and Germany avoided recession. Moreover, November manufacturing surveys (notably IFO and PMI) either stabilised or improved from low levels.
- The formation of the new European Commission was not without uneasy episodes while the Spanish November election was inconclusive. However, the risks that have weighed the most on short term economic developments (Brexit and trade tensions) in 2019 have eased since October.

**Risk factors**

- Trade war and the threat handing over the European automotive sector from US customs duties
- A no-deal Brexit

## United Kingdom

### Towards election and, probably, an orderly Brexit

- Polls currently give an advantage to Tories at the Dec 12 elections. If they indeed win, the UK Parliament will then probably ratify the October Brexit deal with the EU. The UK will then leave the EU in January 2020. If, on the other hand, opposition parties win, the consequence will probably be another referendum to either confirm or cancel Brexit.
- After the Q2 contraction in the economy (with a -0.2% decline in GDP), figures improved in Q3 (+0.3%). However, October retail sales were disappointing.

**Risk factors**

- Uncertainty on the future framework of trade relations with the EU

## Japan

### Q4/19 will be the worst, and a re-acceleration is around the corner

- A sombre global economic landscape continues to take a toll on exports. Along with listless shipments to Europe and Asia, exports to the US are exacerbating the downbeat trend in total shipping. Demand for general machinery has shrunk markedly, reflecting companies' reluctance to undertake capex amid uncertainties in global trade.

**Risk factors**

- Delay in recovery in Southeast Asian economies may hamper capital investment by export-oriented firms

# **Macroeconomic picture** by area

Finalised on 2/12/2019

## Japan

- However, exports of electronics have recovered as the global semiconductor cycle eventually turned around. Consequently, producers' inventories have peaked out. Consumers managed to retain purchasing power even after the VAT hike. The government's decision to make preschool free of charge offset the impact of tax hike by far.
- The government is planning a sizable economic stimulus, primarily to cope with rounds of natural disasters. The size of the package will exceed 1% of GDP.

### Risk factors

- **Stagnant global vehicle sales spoil the broad pyramidal structure of the automobile industry**

## China

- At the end of the latest round of negotiations, a truce was announced between China and the US, based on more agricultural product purchases by China and no tariff rate increases by the US. The truce details are not out yet and in the meantime the bar for the Phase One deal has been raised by China's asking for a rollback on the tariffs in place.
- Chinese macroeconomic data showed some further deterioration in October in Fixed Assets Investments and Manufacturing Production. The trade data are showing some narrowing in the surplus with the US. On the back of an acceleration in land sales, Floor space started jumped more than expected in October.
- The policy mix continues to support the economy in a limited way, through both the monetary and fiscal levers. The PBoC cut the LPR and the MLF by 5bps.
- Credit growth data decreased in October marginally, driven by the core component of RMB Loans and Local Government Bonds.

### Risk factors

- **Bar raised for the Phase One deal on Chinese request for a rollback of the existing tariffs**
- **Some further deterioration in macroeconomic conditions**
- **The policy mix is still very mildly supportive**

## Asia (ex JP & CH)

- Economic conditions in the region remained quite weak in November, with macroeconomic momentum slowing the most in China and Malaysia. The outlook for exports has deteriorated marginally: the first 20 days of exports in South Korea, a sort of leading indicator, have picked up (always in negative double digit growth), due mainly to a base effect kicking in.
- The region's inflation figures have remained very benign. Noteworthy October figures came once again from India and China, with higher-than-expected food basket components (pork prices, in particular, in the case of China), at 4.6% YoY and 3.8% YoY, respectively.
- In November, the Bank of Thailand cut its policy rates by 25bps for the second time in a few months.
- India announced an ambitious divestment plan to complete by the end of the current fiscal year to support poor revenues performance.

### Risk factors

- **Still weak macro momentum in the region. A trade deal is crucial**
- **Inflation still very benign, with a pick-up in China and India**
- **Central banks in the region still accommodative**
- **Malaysia's 2020 budget moderately less consolidating**

## Latam

- Macro momentum in the region has been deteriorating, mainly in Chile and Brazil, while Chile has moved to broadly negative momentum. Following the final release of Q3 2019 Mexican GDP, we again reduced our 2020 growth projections to 0.4% from 0.6%. We also reduced our Chile growth forecasts to around 2.0% for 2019-20.
- On the inflation front, the overall environment remains benign. We revised up our inflation forecasts for Chile marginally, to 3.7% YoY for 2020 following the ongoing currency weakness. Argentina inflation fell slightly below 50%, at 49.7% for the first time since January 2019.

### Risk factors

- **Economic conditions continued to weaken; Mexico growth revised down**
- **Inflation is overall benign but in Argentina**

# **Macroeconomic picture** by area

Finalised on 2/12/2019

## Latam

- The easing stance is continuing with Banxico cutting its policy rates again by 25 bps at 7.50% and Peru by the same amount, to 2.25%.
- Following the violent street protests, President Pinera decided to hold a referendum to replace the Constitution by April 2020. The referendum will decide if and who is going to change the chart.

**Risk factors**

- **Banxico and the Central Bank of Peru cut their policy rates by 25bps**
- **Protests in Chile pushed the President to hold a referendum to change the constitution**

## EMEA (Europe Middle East & Africa)

**Russia: Real GDP growth is expected to slow to 1.2% in 2019. However, growth is expected to accelerate in 2020 and over the medium term on the back of a significant infrastructure spending programme from 2019 to 2024 and a lower-interest-rate environment.**

- Despite the threat of potential US sanctions down the road, the macroeconomic scenario remains supportive. Russia is one of the few emerging market sovereigns with "twin surpluses" in 2019, while accumulating assets in its National Wealth Fund.
- The CBR cut its policy rate again in October by 50bps to 6.5%. We expect another 50bp cut in the next twelve months, given decelerating inflation.

**Risk factors**

- **Drop in oil prices, stepped-up US sanctions and further geopolitical tensions**

**South Africa: strong headwinds with a challenging political and social backdrop**

- Q2 GDP showed more resilience than the market was expecting, thanks mainly to a post-strike recovery in mining. We expect GDP growth of 0.5% YoY in 2019, with a slight pickup in 2020.
- Despite a negative output gap and declining inflation expectations (but above midpoint), the SARB remains cautious regarding capital outflows and the impact on the exchange rate, hence, upside risks to inflation. Fiscal reforms and risk sentiment will determine whether the SARB cuts rates going forward. We expect the SARB to remain on hold in 2020.

**Risk factors**

- **Increased risk aversion, risk of sovereign rating downgrades, rising social demands, and continued fiscal slippage in the absence of reforms**

**Turkey: inflation is on the decline and GDP growth picked up in Q3- 2019**

- The third-quarter growth report showed +0.9% GDP growth YoY, relative to a negative release from the previous two quarters. We expect GDP growth to be flat or slightly negative in 2019, and a rebound in 2020, accompanied by a lax fiscal stance.
- The Central Bank of Turkey cut its policy rate significantly in October, by 250bps to 14%. We expect some more easing to come in support of weak economic conditions.

**Risk factors**

- **Excessive easing by the central bank, a loose fiscal stance, escalation of geopolitical tensions, and a slowdown in Eurozone activity.**

# Macro and Market forecasts

## Macroeconomic forecasts
(4 December 2019)

| Annual averages (%) | Real GDP growth % | | | Inflation (CPI, yoy, %) | | |
|---|---|---|---|---|---|---|
| | 2019 | 2020 | 2021 | 2019 | 2020 | 2021 |
| **US** | **2.3** | **1.7** | **1.7** | **1.8** | **2.3** | **2.1** |
| **Japan** | **1.0** | **0.5** | **0.0** | **0.8** | **1.0** | **0.0** |
| **Eurozone** | **1.1** | **1.1** | **1.3** | **1.3** | **1.3** | **1.4** |
| Germany | 0.6 | 0.8 | 1.2 | 1.5 | 1.5 | 1.5 |
| France | 1.3 | 1.3 | 1.2 | 1.4 | 1.4 | 1.3 |
| Italy | 0.2 | 0.4 | 0.6 | 0.6 | 1.0 | 1.3 |
| Spain | 2.0 | 1.6 | 1.6 | 0.9 | 1.3 | 1.4 |
| **UK** | **1.3** | **1.1** | **1.4** | **1.8** | **2.2** | **2.1** |
| Brazil | 0.9 | 1.6 | 1.7 | 3.7 | 3.9 | 4.2 |
| Mexico | -0.2 | 0.4 | 1.2 | 3.6 | 3.4 | 3.6 |
| Russia | 1.2 | 1.7 | 2.5 | 4.0 | 3.5 | 4.0 |
| India | 5.2 | 5.8 | 6.4 | 3.4 | 4.3 | 4.1 |
| Indonesia | 5.0 | 5.1 | 5.3 | 3.0 | 3.1 | 3.8 |
| China | 6.2 | 5.8 | 5.8 | 2.6 | 2.6 | 2.0 |
| Turkey | -1.8 | 1.5 | 2.3 | 15.6 | 11.6 | 10.8 |
| Developed countries | **1.7** | **1.4** | **1.4** | **1.5** | **1.8** | **1.6** |
| Emerging countries | **4.1** | **4.3** | **4.6** | **4.0** | **3.9** | **3.6** |
| World | **3.1** | **3.1** | **3.3** | **3.0** | **3.1** | **2.8** |

*Source: Amundi Research*

## Key interest rate outlook

| | 29/11/2019 | Amundi + 6m. | Consensus Q2 2020 | Amundi + 12m. | Consensus Q4 2020 |
|---|---|---|---|---|---|
| US | 1,75 | 1,50 | 1,60 | 1,50 | 1,60 |
| Eurozone | -0,50 | -0,50 | -0,50 | -0,50 | -0,50 |
| Japan | -0,1 | -0,2 | -0,16 | -0,2 | -0,05 |
| UK | 0,75 | 0,75 | 0,87 | 0,75 | 0,96 |

## Long rate outlook

### 2Y. Bond yield

| | 29/11/2019 | Amundi + 6m. | Forward + 6m. | Amundi + 12m. | Forward + 12m. |
|---|---|---|---|---|---|
| US | 1.62 | 1.30/1.50 | 1.61 | 1.30/1.50 | 1.62 |
| Germany | -0.629 | -0.70/-0.50 | -0.66 | -0.70/-0.50 | -0.67 |
| Japan | -0.169 | -0.30/-0.20 | -0.19 | -0.30/-0.20 | -0.21 |
| UK | 0.532 | 0.30/0.50 | 0.40 | 0.30/0.50 | 0.38 |

### 10Y. Bond yield

| | 29/11/2019 | Amundi + 6m. | Forward + 6m. | Amundi + 12m. | Forward + 12m. |
|---|---|---|---|---|---|
| US | 1.77 | 1.60/1.80 | 1.80 | 1.50/1.70 | 1.85 |
| Germany | -0.36 | -0.30/-0.10 | -0.31 | -0.40/-0.20 | -0.27 |
| Japan | -0.07 | -0.20/0.00 | -0.04 | -0.20/0.00 | -0.01 |
| UK | 0.68 | 0.70/0.90 | 0.71 | 0.70/0.90 | 0.76 |

## Currency outlook

| | 28/11/2019 | Amundi + 6m. | Consensus Q2 2020 | Amundi + 12m. | Consensus Q4 2020 |
|---|---|---|---|---|---|
| EUR/USD | 1.10 | 1.10 | 1.13 | 1.13 | 1.16 |
| USD/JPY | 110 | 106 | 107 | 104 | 105 |
| EUR/GBP | 0.85 | 0.85 | 0.86 | 0.86 | 0.86 |
| EUR/CHF | 1.10 | 1.12 | 1.12 | 1.11 | 1.13 |
| EUR/NOK | 10.09 | 9.89 | 9.88 | 10.07 | 9.80 |
| EUR/SEK | 10.52 | 10.65 | 10.65 | 10.56 | 10.50 |
| USD/CAD | 1.33 | 1.30 | 1.31 | 1.28 | 1.30 |
| AUD/USD | 0.68 | 0.69 | 0.69 | 0.70 | 0.70 |
| NZD/USD | 0.64 | 0.64 | 0.64 | 0.65 | 0.65 |
| USD/CNY | 7.04 | 7.10 | 7.13 | 7.15 | 7.10 |

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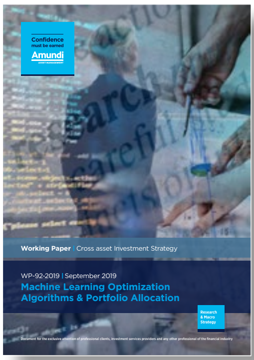


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