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Confidence must be earned

Amundi
ASSET MANAGEMENT

CROSS ASSET

INVESTMENT STRATEGY

2018 and beyond

SPECIAL ISSUE

RESEARCH STRATEGY & ANALYSIS

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Group CIO's Editorial

2018: Risk rotation, before reduction

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

"*What disturbs men's minds is not events but their judgements on events*", Epictetus

We believe 2018 will mark the **transition** from a full-speed reflationary phase, directional and bullish for risk assets (both credit and equities), towards a late phase of the financial market cycle. This could have far-reaching consequences for investors.

First of all, in terms of **opportunities** remaining in the market. In our view, in a world of stretched valuations across the board and interest rates trending higher, these opportunities will lie less in the directional space and more in relative value stories at the country, sector and/or security level, with rotation of markets, themes and styles taking place during the year. Based on a cross-asset perspective, this rotation will favour equities over credit, in our view: in equities, Europe and Japan and, selectively, some emerging markets (countries in the earlier stage of the financial cycle), value and themes point towards inflation-related stocks and companies which may benefit from higher interest rates; in fixed income, a flexible approach to duration, yield curves and currencies (due to different speeds in removing monetary accommodation, i.e., higher in the US than in the Eurozone and Japan) and across the full credit spectrum (liquid and illiquid).

The expected transition will not be linear. Identifying inflection points and focusing on detecting possible bubbles in the market, as well as to implementing strategies to mitigate **risk** will be crucial. In this respect, the main challenge we see in 2018 is **market complacency**. The global economy will likely continue to enjoy a sweet spot, with the main developed economies growing above potential and emerging markets benefiting from a nice synchronisation of the global cycle. Inflation is expected to remain modest, but rising, especially in the US, where a tightening labour market is starting to transfer some pressure on to wages. In this environment, central banks will likely continue to repeat the mantra of gradual normalisation, with the aim of keeping market volatility low and financial conditions easy. The perception of control and of central banks providing a safety net in a benign economic outlook will likely drive another wave of market appreciation and optimism in the first part of the year, supported by sound earnings growth. This could further fuel valuations in the search for income themes and expose financial markets (especially fixed income) to the risk of an abrupt wake-up call, should inflation start to pick up, with (nominal and real) interest rates rising as a consequence of stronger growth, and central banks appearing increasingly out of touch in their monetary policy measures.

As a consequence of complacency risk, we believe investors **should adapt portfolio construction through the year to changes in circumstances**, moving from a "**rotation** of risk exposure" approach towards a more precise "**reduction** of risk exposure" to the most crowded areas of the market (low-quality credit, momentum trades). At the same time, they will need to take action to improve **liquidity buffers** in portfolios and further focus on downside risk mitigation in case of tail events or alternative scenarios coming to the fore. In this respect, we believe there are geopolitical factors that still have not been fully priced in by the markets (e.g., Brexit, Middle East tensions) and the higher probability of an upward revision of inflation expectations, with a further acceleration in global growth in 2018. Therefore, investors should continue to implement hedging strategies, trough options, cash and low correlated assets, in order to limit losses when higher volatility materialises.

In conclusion, **our main message for investors regarding 2018.** We don't foresee imminent risks and major distortions (macro and asset prices) driving a deep market sell-off. Thus, investors should maintain some exposure to risk assets. However, we believe they should use the time resulting from a period of prudent monetary policies to rotate and recalibrate risks in their portfolios during the year towards a more defensive positioning, with a strong focus on quality. Based on a barbell allocation to cash (as a risk-free safe asset to manage the portfolio liquidity profile and play tactical opportunities) and growth opportunities (both in the liquid and illiquid spaces), we believe investors can optimise return potential and help to manage portfolio liquidity profiles in the delicate transition towards a more mature phase of the financial market cycle.

Economic Backdrop and Investment Scenarios: 2018 and Beyond

Resilient growth... but debatable market valuation

DIDIER BOROWSKI, Head of Macroeconomic Research
MONICA DEFEND, Head of Strategy, Deputy Head of Research
PHILIPPE ITHURBIDE, Global Head of Research

The essential

Global economic conditions are benign thanks to a highly accommodative monetary and financial environment while trade multipliers have magnified the re-synchronisation of the global cycle, the recovery in global investments and corporate profits (and specifically EPS momentum). The weak relationship between growth and inflation marks this cycle as unique.

Going into 2018, we expect a progressive rebalancing between monetary and fiscal policies. Core inflation, while reaccelerating in some regions (namely USA, eurozone), will remain subdued by historical standards.

Within this framework, we expect a smooth transition from an asset reflation regime towards a late financial cycle regime. The main characteristics thereof will be Central Banks progressively removing their excessive accommodation, smoothly reducing global liquidity conditions, maintaining accommodative financing conditions and eventually lower risk-adjusted expected returns.

Looking at the financial markets in fact, absolute valuations on both fixed income and equity are, on average, stretched. However, interest-rate lift will be contained allowing some space for further multiple expansion. This is a risk-asset-friendly environment where relative rather than straight directional positioning in global equity, global fixed income and FX spaces has to be favoured. In fact, the search for profitable investment opportunities should emphasise duration diversification and sector/style/factor selection in equity land.

We believe that inflation surprises, rate increases that exceed market tolerance and drying liquidity against a backdrop of increased geopolitical tensions, are major sources of risk worth hedging.

Base case scenario: a cyclical upswing that has still further to go
Probability 75%

In the base-case scenario, GDP growth rates are expected to stabilise at most around current levels. Under present conditions, we may have already seen the best of it in terms of momentum, but the cyclical upswing (global synchronisation, global investment recovery, global trade rebound) may still go on without a material increase in inflationary pressure. **The more synchronised the recovery, the more robust and resilient the global economy.**

What is puzzling at this stage is the **weak relationship between growth and inflation**. There is a structural slowdown in inflation due to supply factors. Non-energy-industrial goods inflation is persistently low and also declining, due to fierce global competition. In addition, the cyclical component of inflation has weakened (flattening of the Phillips curve). Globalisation, the spread of innovation, weaker unions and rising labour-market flexibility (temporary contracts, etc.) will continue to contain price and wage pressures looking ahead.

Central banks (CBs) are clearly disoriented by the strong growth/low inflation conundrum. They are not only busy encrypting the new set of economic relationships between inflation, unemployment, productivity and wages. CBs also have in mind that they face conflicting objectives: maintaining growth, inflation and financial stability at the same time might prove challenging.

This is indeed a complex and unusual situation for central banks:

- On the positive side, the low level of rates in a widespread benign growth environment creates virtuous conditions to correct imbalances, reduce the public debt burden and converge to improved debt sustainability in the long-term (see eurozone evidence). Should policy be successful in delivering tax reforms and structural reforms in a reasonable time, it would complete the transition towards more sustainable and inclusive growth.
- But on the other hand, excessively accommodative monetary conditions may generate the next financial crisis (multiple asset price bubbles) at a time when the world has hardly started to deleverage (global debt has reached an all-time high).

In other words, while reflation results from the level of monetary accommodation, an excessive level of monetary accommodation may, at the end of the day, pave the way for the next financial crisis and thus for a global downturn that would ultimately prove deflationary (debt-deflation spiral). **Subsequently, CBs are in a delicate position: they need to simultaneously remove excessive accommodation and avoid tightening monetary conditions too quickly.**

Against this backdrop, **we believe the biggest global risk is related to policy implementation or policy mistakes (not only monetary, but also fiscal, trade, reforms). Among the risk factors often mentioned, we believe that a recession in the US or a hard landing in China are unlikely to occur in 2018-2019. From an economic standpoint, we believe that risks are slightly tilted to the upside in the coming quarters.**

MACRO	FINANCIAL MARKETS	INVESTMENT CONSEQUENCES
– Resynchronisation of the global cycle: more robust growth ahead, mostly domestic driven, magnified by trade multipliers	– EPS expand on later cycle mode, corporate profits reduce cash holdings and dividend payout, buy backs, M&A activity cools down	• Positive for risk asset exposure • Risk-adjusted returns lower than previous asset reflation regime
– Toward a rebalancing of monetary and fiscal policies in some key countries. Central banks progressively removing excessive accommodation	– Fixed income and equity absolute valuations are on average stretched, interest rates expected to increase only moderately	• Transition from asset reflation into late financial cycle regime • Gradual rotation from High Yield into global equity
– From excessively low inflation to subdued inflation, risks skewed to the upside	– Fixed income and equity absolute valuations are on average stretched, interest rates expected to increase only moderately	• Relative positioning to replace directional positioning. • Emphasise geographical diversification in duration management. • Global equity positioning articulated on country/sectors/style/size/factors
RISKS	**– Inflation and rates surprises** **– Geopolitical risks (Brexit, Middle East, North Korea)** **– Oil price spikes and drying market liquidity**	**• Gold** **• Risk sensitive FX cross (AUD/JPY)** **• US linkers**

Large economies at a glance

United States: a mature cycle but no recession in sight. The cycle is ageing (almost nine years) but an extension in 2018-2019 is likely thanks to fiscal policy, low inflation and still accommodative monetary and financial conditions. We forecast growth at – or above – 2% in 2018 and 2019. Given the uncertainty still surrounding the final definition of the tax reform bill, it is difficult to evaluate the impact of tax reform on our projections, both in terms of the short-term boost to GDP and the long-term increase in potential growth. Assuming that the reform is delivered in Q1 2018, we estimate that the resulting boost on our forecast would range from +0.1% (case of low multiplier effect) to +0.5% (case of high multiplier) on top of our base case (see table). If, as we expect, the ongoing cycle continues after mid-2019, it would become the longest expansion phase on record (since 1857).

Eurozone: the "Renaissance". The late-recovery is now broadening to all countries and GDP components. Thanks to accommodative monetary and credit conditions, growth is expected to remain above potential for several consecutive years. Notable progress has been made in implementing reforms at both the EU and national levels and most macroeconomic imbalances have been corrected. Even though some local-risks remain, political stability has improved and uncertainty about the whole EU architecture has diminished. European citizens have become more optimistic about the EU and the euro as a single currency. And we expect a strong commitment from eurozone governments to continue to make reforms and to strengthen the European project. Hence, our belief in the "Renaissance" of Europe.

UK: it's all about politics. The Brexit clock is ticking and the positions of the UK and the EU in negotiations remain far apart. The UK is the only large European economy which has slowed in 2017. The risk of a "very hard" Brexit (no deal) has risen. Even though it is not our central scenario, we expect the Brexit-related uncertainty to weigh heavily on investment decisions, both from corporations and households (the latter regarding real estate in particular). But the UK economic slowdown is not expected to derail the recovery in the eurozone, which is primarily driven by domestic demand.

Japan: Abenomics will boost Japan toward the longest post-war expansion. The economy is not particularly strong by historical standards but this cycle has proved more robust than expected, driven both by domestic demand and global trade. Strong corporate profits should sustain business investment while – following the recent snap elections and the ruling coalition's victory – fiscal policy will turn more expansionist in 2018. Should the expansion continue beyond 2018, as we expect, it would become the longest expansion phase since WWII.

China: resilient growth and more balanced reforms ahead. The economy appears more resilient than previously believed. The (widely expected) coming slowdown is likely to be moderate, as growth drivers are now more broad-based and meaningful supply-side adjustments, including cuts in overcapacity and property inventory reduction, have already materialised. The 19th Party Congress confirmed that among the top priorities were the deepening of reforms and the improvement of governance which would increase the chance of China successfully managing a relatively soft landing.

Global Emerging: less vulnerable than before the Great Financial Crisis (GFC). Most emerging economies are enjoying strong growth momentum, with solid domestic demand. Short-term prospects could prove bumpy (Fed QT, political gridlocks, etc.), but all in all the medium-term outlook remains promising. Since the GFC, external vulnerabilities have indeed diminished in many countries.

Monetary policies

The Federal Reserve balance sheet will start to gradually reduce over the next four years. Conversely, the ECB and the BoJ balance sheets will continue to rise, albeit at a slower pace. All in all, the global monetary base (central bank liquidity) will continue to expand next year despite a synchronised economic recovery. Such a configuration is unique. Logically, it is in the United States – where the cycle is the most advanced and the economy close to full employment – that the central bank has the most reason to hike rates. However, even there, the level of domestic leverage (in particular for non-financial corporates) requires proceeding with caution. Thus, global monetary conditions will remain accommodative with key real interest rates at exceptionally low levels.

- **Federal Reserve.** We expect the Fed to raise rates once more in 2017 (+25bp in December) and twice in 2018. Should our upside scenario materialise (positive growth surprise coming from a tax reform boost) one (or even two hikes) would be possible: all things being equal, the fiscal easing would indeed call for less monetary accommodation. Nevertheless, for such a policy to be put in place, growth and inflation would need to accelerate simultaneously.

  The appointment of a new Fed chair does not change the outlook. Jerome Powell – who will succeed Janet Yellen in February 2018 – is the candidate of continuity when it comes to QE and interest-rate normalisation, while he is more open than his predecessors on the subject of financial regulation. Like his two predecessors, he thinks that the equilibrium interest rate has fallen and that inflation is not threatening. In addition, he has always supported monetary policy decisions since his appointment at the Fed in 2012, and stressed the importance of monetary and financial conditions (US dollar, long-term bond yields, credit spreads, and equity markets). It turns out that the Fed's «reaction function» will remain flexible and its action opportunistic. Therefore, if an expansionary fiscal policy calls for a rebalancing of the policy mix, with less monetary accommodation, it will be small steps. The risk of a rise in the US dollar and long rates requires a cautious approach.

- **European Central Bank.** The last ECB meeting clarified the monetary strategy. The Asset Purchasing Programme (APP) will continue at €60 bn per month until December and then the size of purchases will be reduced to €30 bn per month starting from January, until September 2018. The ECB Council stands ready to increase the APP in terms of either size or duration, if needed (hence the programme remains open-ended). In addition, the ECB will not end the programme abruptly so there will likely be a phase-out period. The ECB clarified that reinvestments will continue for an extended period of time (after the end of its APP). Regarding forward guidance on rates, Mario Draghi said that they will remain at their present levels for an extended period of time, and well past the horizon of the net asset purchases. **All in all, the ECB's tapering appears quite dovish. We do not expect the first rate hike before 2019.**

- **Bank of England.** While the market is pricing in a continuation of the tightening action next year, we think that the impending slowdown (not a recession but an uncertainty-led slowdown) will prevent the BoE from entering into a tightening cycle. Even though some pressure on prices is likely to persist due to the weakness of the currency, inflation should in any case move down from the current levels.

- **Bank of Japan.** Following Abe's victory in the recent parliamentary elections, Governor Kuroda is likely to be reappointed. The BoJ significantly lowered its inflation outlook and should thus stick to its current policy and maintain the framework of QQE plus YCC (yield curve control). Yet, the promised annual purchase level of JPY 80 trillion is difficult in practice and, in fact, the central bank has already whittled its purchases down to some 60 trillion.

- **People's Bank of China.** The PBoC's stance should be roughly neutral, with possible fine-tuning. It is unlikely to be too tight, as the economy is expected to cool somewhat, while inflation should evolve within the comfortable range. Benchmark rates are expected to remain where they are.

RISK SCENARIOS

DOWNSIDE RISK SCENARIO (10%)
Economic slowdown due to poor implementation of economic policies, to policy mistakes or to a sudden repricing of risks in fixed income markets

RATIONALE	CONSEQUENCES
• Fiscal policy poorly designed and implemented (in the US in particular). • Monetary policy mistakes (the normalisation process proves too fast). • Rise in protectionism. • Poor governance in Europe / no progress on reforms.	• Growth slows and inflation stabilises lower (though not necessarily a case of deflation). • Disorderly deleveraging. • Central banks forced to restart the use of unconventional tools but market liquidity contracts. • Sudden repricing of risks in fixed income markets, with widespread spread decompression (credit and govies, both in advanced and emerging economies).

UPSIDE RISK SCENARIO (15%)
Further acceleration of global growth in 2018

RATIONALE	CONSEQUENCES
• Acceleration driven by business investment, global trade and the resynchronisation of the global cycle. • Fiscal stimulus in the US, continuation of the cyclical acceleration in the eurozone, stabilisation in China, confirmation of the trend in Japan etc. • With still low inflation, central banks would initially maintain soft monetary conditions, fuelling a mini-boom.	• Rise in inflation expectations. • Central banks would, at the end of the day, need to reconsider the pace of normalisation, with a rise in real key rates (in the US notably). • Boom-bust risk (i.e. the bust after the boom).

Keep in mind the structural headwinds

The current global cyclical upswing can last longer than initially expected but cyclical upswings are by essence temporary. It's all the more true that there are numerous headwinds.

While we can be reasonably reassured by the short-term prospects, both governments and investors seem too complacent about the medium-term outlook. Rising debts, rising inequalities, impoverishment of the middle class (with wage stagnation), challenges posed by the ageing population, slow productivity gains, or – in another vein – by climate change, and the accelerated pace of robotisation. The list of "structural headwinds" is long, not to mention geopolitical threats. The world is rapidly changing. Most of these challenges may have huge social and political consequences in the medium term that would inevitably affect the macrofinancial outlook. Global action is needed. But so far, we've seen little will to deal with these issues.

In the medium term – assuming some global action is taken to deal with these structural issues – we would expect GDP growth to stabilise around its potential. On a three-year horizon, global growth would stand at around 3.5%, below the average observed over the past decades.

- **Nominal potential growth is trending lower:**
  - **Real potential growth is trending lower** worldwide due to the ageing populations and slow productivity gains
  - **"Structural inflation" has dropped over the past three decades.** Persistent downward pressure is likely to continue to result from global supply-side factors. Structural factors such as globalisation, the spread of innovation, weaker unions or rising labour-market flexibility (temporary contracts etc.) will continue to contain price and wage pressures looking ahead
- **Global debt** (government, households and non-financial corporates) **has increased to an all-time high at the end of 2016** (265% of GDP for the G7 countries): +100pp over the past 30 years, half of which has occurred since the Great Financial Crisis
  - Very different situations across countries (level and composition of debt). For instance, in China, non-financial corporate debt has jumped while the most advanced economies are struggling with excessive public debts
  - In the US, China, the UK and the eurozone, total debt stands at around 250% of GDP (end 2016)
- **The "global deleveraging" has hardly started.** Thus, financial repression will continue. In addition to the slowdown in potential growth, we expect global deleveraging to drag down GDP growth in the years to come.

- **Against this backdrop, central banks are implicitly incentivised to maintain low real key rates:** a certain dose of financial repression is probably necessary to engineer an orderly deleveraging at a global level (a disorderly or brutal deleveraging would renew deflationary pressure).

Investment themes

Economic backdrop plays a relevant role setting the prevailing financial regimes for the year to come. If we systematically consider growth, price dynamics, monetary policy stance and leverage, we conclude that around late Q2 2018 we should transition from an asset reflation regime into a late financial cycle regime against a backdrop of consolidating growth and subdued inflation.

The key factor driving these regimes' transition will be the central banks "beautiful" normalisation while inflation expectations and rates (both real and nominal) will represent the leit motiv shaping this year's investment consequences both in the base and alternative risk scenarios.

Inflation paths and real rate dynamics will in fact define the pace of CBs calibration of frontline tools, eventually shaping the yield curve and hence the relative valuation case between equity and bonds. Stock markets are expensive in absolute terms but relative valuations to bonds are not extreme. Depending on CBs, liquidity will (have to) remain adequate and we may possibly observe some **selective depreciation in the FX space** as a consequence of how intensely central banks move forward with their normalisation cycles. As rates after all will only increase moderately, the **search for yield** will remain, but in the credit spectrum it will turn more selective on sectors and rating due mainly to valuation considerations. We expect **risk assets** to perform and the **rotation from credit into equity** to occur eventually on broad risk/return and valuation considerations. **Interest rates will moderately rise** on less intense QE, likely above what the market is currently pricing. **Equity markets** will rely on a contained level of unit labour costs that will preserve margins, and EPS consolidation, while the low level of rates keeps the case for relative valuations alive.

However, it is worth considering the **mature phase of the economic and profit cycles**, the **valuation** component and the **gradual QE withdrawal**. On these considerations, risk-adjusted returns will be lower than in the previous asset reflation regime. Therefore, investment opportunities will lie less in the directional space and more on relative value stories at country, sector and size level. In **global equity** land, **quality and value** are the themes that will be recurrent both from a **top down perspective and bottom up selection**. Moreover, different stages of the EPS cycle and valuations will be tilting the regional equity allocation. Initially, the preference will be for Europe, Japan and Emerging Asia in particular, but we will likely rotate regional preferences during the year. In particular, what the FED will deliver (number of hikes, balance sheet shrinkage and resulting USD dynamics) will be key in identifying the spillovers for the global financial markets.

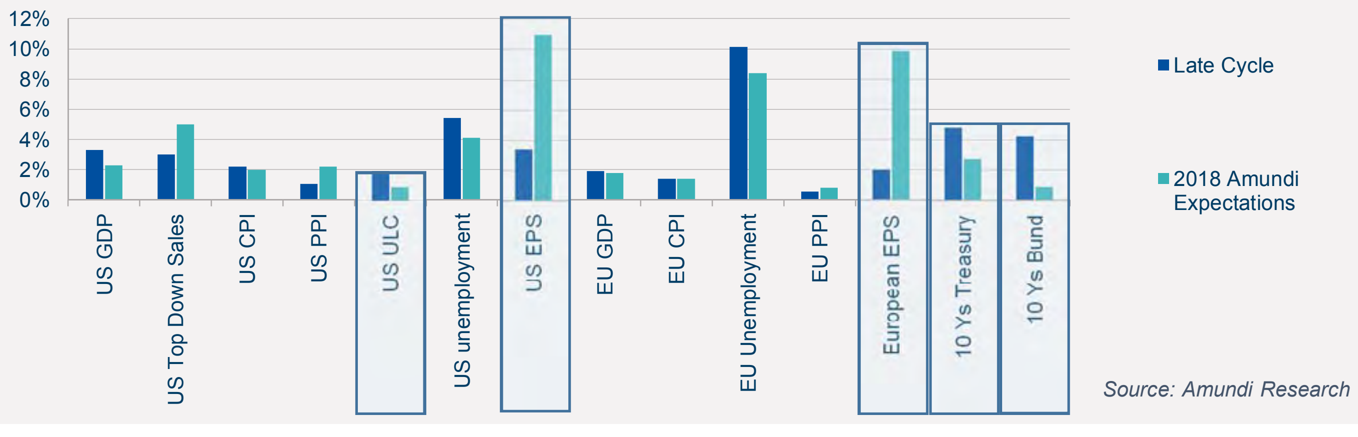
Actually, inflation and rates will also be key when turning to risks and alternative scenarios. In fact, extremely low market volatility and high levels of complacency leave the door open to upside inflation surprises, a snapback of long-term interest rates and eventually to geopolitical risks. The macro-hedging component deserves particular attention, considering the absence of real asset diversifier in the portfolios' allocation.

There are **three main aspects** differentiating the forthcoming late financial cycle regime from the past and turning it into an unprecedented situation. We have to consider them when assessing the potential of the asset class and defining investment guidelines.

The **subdued level of US unit labour costs coupled with the rosy growth scenario** and the tightening conditions on the labour market. While marginally increasing, unit labour costs are far from an accurate gauge of inflationary pressures but they are keeping up the pressure on corporate earnings margins.

The **low level of nominal rates**, in the long end of the developed-market yield curve. They are at barely half the level of historical rates and preserve the relative valuation case for equities versus bonds.

1/ This time is different: Distinctive features of 2018 financial regime



The **resynchronisation of global EPS and upbeat momentum**, albeit for different reasons in the USA (margins and USD), Europe (top line growth), Japan (restructuring and improving fundamentals) and eventually Emerging Markets (improving but maturing economic cycle).

What's priced in already?

When we compare the expected macro target prices (i.e. the expected fair value price level consistent with our macro base scenario expectations) and the historical returns of the main asset classes in a late financial cycle regime, we conclude that global markets have already priced in a good part of the expected economic dynamics. This is one of the reasons to justify relative trade being preferred over directional positioning, and country, sector, and style rotation (both in the fixed income and equity space). Other factors of tactical nature (i.e. risk sentiment, positioning) have to be considered to improve the risk reward within allocations.

BASE SCENARIO - TOP DOWN INVESTMENT IMPLICATIONS

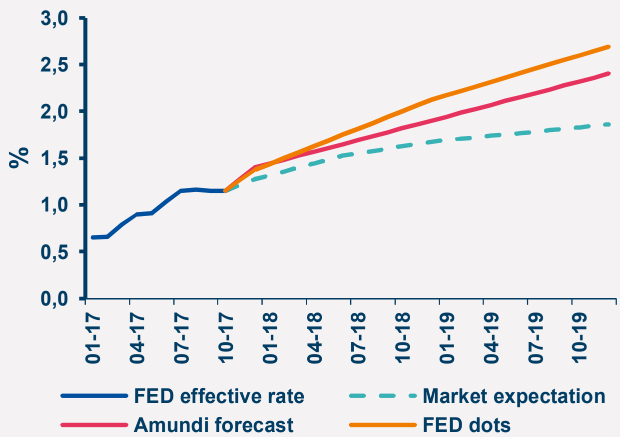
- Risk On with macro hedging on selected key risks (inflation surprises, yield decompression, market sell-off, geopolitical)
- Credit preferred to Govies, EU IG in particular. Selection on sector and rating on the credit spectrum.
- Flexibility in duration management, relative country positioning
- Rotation from credit (US HY) into global equity
- Regional equity preference for Europe, Japan, selective on EM countries but rotation likely. Quality and Value and key investment themes

The economic backdrop (growth, inflation) justifies a risk-on positioning. As cross asset risk/return profiles are likely to be lower than the past, absolute valuations are compressed (with the exception of volatility) and correlations positive and very closed, diversification on relative trades cross asset, regions, sectors, rating and style will be key. Credit valuations fell to quite rich levels: US companies are in a more mature phase of the cycle when it comes both to credit metrics (leverage) or technical. Vice versa, in the eurozone, the ECB via CSPP is likely to remain the big supporter of the IG market, notwithstanding that there is no significant re-leveraging (non-financials) and the level of cash and coverage ratios remain in a bright spot.

DM Long-term yields, still low on an historical comparison, might rise even more than indicated by forward rates on less intense central-bank QE policies. In fact, the speed of monetary policy recalibration will set the pace of the movements: as in 2017, the short and long ends of the curves will likely continue to follow different patterns both in the US but also in Germany. Curve steepening is likely in the eurozone: the short end should remain broadly anchored to the ECB's forward guidance, while we expect some risk premium to be built back, with the ECB gradually moving into a normalisation stance (notwithstanding their assertions on the forward guidance).

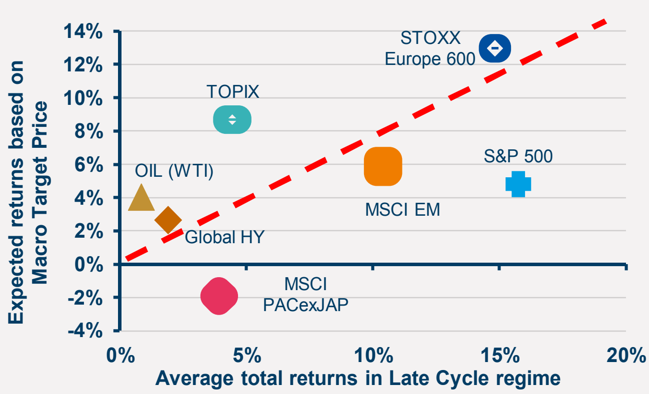
- **In Europe,** the PSPP will remain supportive for peripheral bonds. The increasing deviations from capital key rules will benefit French, Italian, Belgian and Austrian bonds and the maturity of Eurosystem purchases will remain far higher for peripherals than for the purchases of German securities. Political risk needs to be considered (i.e. Italian elections) for short-term volatility or temporary spread widening but the recent ratings upgrades (over the last few months, Italy and Portugal have been upgraded by S&P and Ireland by Moody's) are positive news.

2/ FED funds rate



Source: Amundi Research

3/ Fair value total returns conditioned on late cycle



The chart 3 considers the Expected Macro Target Price (or fair value) on the Y-axis as the theoretical price level consistent with our expected macro scenario. The gap versus the historical price (X-axis) calculated on similar past regimes define the upside/downside potential. The 45° row is where target price expectations equals historical total return. Above this line, asset classes have positive potential (negative when below).

- **In the US,** we expect a contained flattening, with the FED continuing its smooth hiking cycle. The main risk to this view is the potential implementation of substantial tax reforms. Should this be the case, the FED will have to temper the increased room for hiking with the significant spillover to the financial markets.

In light of these considerations, flexibility and geographic diversification in duration management to seek out relative value between countries need to be considered.

Break-even rates should normalise in the eurozone from a too depressed level as we expect a gradual increase in eurozone core inflation. Vice versa in the USA, where breakevens are fairly priced. However, they remain a good hedge in case of inflation surprises, a risk listed in our wall of worries.

DM FX will prove once again to be very resilient and implicitly reactive to distortion from policies (Yen, USD) & politics (GBP). The **euro** is expected to remain subdued within the current trading range in the first part of the year and then moderately appreciate towards 1.22 on short-term interest-rate differentials and improving macro fundamentals. The **yen** will remain driven by interest rate differentials, we expect it to stay within the 115-118 range vs. the dollar. Brexit negotiations will drag down the UK economy and the BoE's reaction function. We expect the GBP to remain within 1.26-1.28 vs. the USD. The trade-weighted EUR will appreciate almost 3%, while the DXY will depreciate by almost the same amount.

Global equity markets will rely on the consolidation of the EPS cycle, the contained level of unit labour costs that will preserve margins on average while the low level of rates keeps the case for relative valuations alive.

EPS growth will be key and differences in pace will likely favour country and sector rotation themes. In general, EPS are going to be higher (in Europe and in the US in particular) than what we are used to seeing in similar consolidation phases in the past. The reasons being the supportive financing conditions, buoyant markets that helped foster growth and repair balance sheets, accumulation of cash ready to be eventually allocated to investments (capex), as has started to be the case in the US, recently in Europe and expected to occur in Japan. Then, at regional level:

- In the **US, subdued pressure on wages is underpinning margins,** while the overall **dollar depreciation** in 2017 allowed some further momentum in the most recent reporting season.
- **Europe and the EM are eventually bottoming out.** The latter in particular after four years of negative earnings growth, in 2017 for the first time, company results outperformed expectations. Earnings growth will remain above the historical average in 2018 but with a cooling momentum on a more mature cycle.
- **Japan is surprising on the upside** on tangibly improving fundamentals, independently from the yen (that remains crucial nonetheless).

EM Bond (hard currency) levels are on average expensive, notwithstanding the expectations that the EMBI spread will tighten (from 360 to 340). We reiterate the case for selection and a relative value approach at single country level with improving fundamentals, credible reform agenda, attractive valuation and risk adjusted carry. Positioning is heavy but in the main scenario, we expect outflows to be thin, even if CBs in DMs turn less accommodative. We believe we have seen the best out of EM debt in local currency: going forward valuations and real rates show limited room as inflation will stay around central banks' targets. The correction of external imbalances will avoid downside risk, though it would be better to be exposed to those countries with lower sensitivity to US rates, should they rise more than expected. **EM FX** continues to show attractive carry and, over the medium term, valuations are appealing for the selection of high carry/low volatility currencies with low external vulnerability.

Financial implications of alternative risk scenarios

The bulk of our outlook are central banks smoothly normalising their stance while rates and inflation expectations advance gradually to higher levels.

Asset reflation allowed financial markets to perform thanks to low rates, lowflation and QE. As soon as inflation starts to rise, interest rates will unequivocally prove unsustainable at current levels. This will then challenge equities on higher pressure on margins, consuming the undervaluation gap versus bonds.

The Double Bear Markets Risk

In our base scenario, we are confident that interest rates will increase because of QE withdrawal and likely higher inflation. The alternative scenarios mentioned in the previous pages relates to **how far and how fast** rates will move. This is crucial when gauging the probability of a **bear market in global equity and bond lands** and positioning the portfolios to hedge potential losses on both asset class categories.

According to our analyses and considering past empirical evidence, the **critical threshold for 10-year Treasuries** to initiate a double bear market would be around 3.5% (an increase of 125 bps from current levels). In the past, in such circumstances, both fixed income and equities underperformed while gold proved to be the real safe haven.

WALL OF WORRIES (tail risk events)

	DESCRIPTION	MARKET CONSEQUENCES	RISK
FISCAL POLICY MISTAKES **Economic slowdown due to poor implementation of economic policies and/or policy mistakes**			
US	Fiscal policy too poorly designed	Low growth, low inflation, low rates, drying liquidity. Recession risk	High
EU	Slow progress on structural reforms in some countries		Low
EM	Short term: too early/too fast step out of fiscal support or too quick fiscal consolidation Medium Term: lack of necessary structural reforms		Medium
MONETARY POLICY MISTAKES **Central Banks start normalising but timing & sizing produce financial instability and bear markets**			
Global	Synchronised full normalisation of major central banks' monetary policy	Lower global liquidity, spread widening, rates increasing and fixed income sell-off, competitive devaluations and GEM asset classes under pressure	Medium
Global	Monetary trap: while proceeding in the B/S adjustments, real rates increase on bond supply and demand dynamics not on corroborating growth and inflation. Macro and micro fundamentals decouple and central banks are pushed back into monetary accommodation l	Real rates increase and initiate a bear market in both equity and bond space (Double bear market)	Medium
US	Fed recalibrating frontline unconventional tools too fast: rough B/S adjustments/ hikes too fast/ rates move higher than market expectations	Real Rates increase and initiate a bear market in both equity and bond space (Double bear market)	Medium
ECONOMIC **Inflation surprises in both directions with asymmetric probabilities**			
Lowflation	Getting lower not necessarily to deflation but structurally below CBs targets	Real rates increase above market tolerance but lowflation stays, causing growth to decline when central-bank backup diminished. Sell-off in the equity market to hedge the widening in the credit spreads	High
Higher Inflation	Unexpectedly moves higher and persistently above CBs' targets	Depends on CBs reaction function to normalise policy. Higher volatility in the fixed income space o inflation surprises	Medium
Competitive Devaluations	After a market-driven FX appreciation that proves to be persistent when growth ends up not being strong enough to offset the competitiveness loss	Commodities and profits recession, competitive devaluations, risky asset sell-off	Medium
GEOPOLITICAL			
Brexit process	Uncertainty on final outcome of the negotiations	Weaker UK (economy, financial markets, GBP)	High
Italian elections	Coalition Government weak in the delivery of structural reforms	Sovereign spread widening	Medium
North Korea military escalation	Global conflict	Risk Off	Low
Tensions in the Middle East on Saudi policy	Significant regional conflict with global spillover	Local economies and markets weakening, volatility increase, oil price upside risk	Medium
MARKETS SELL-OFF			
Boom Bust Bubble	Decoupling of fundamentals and asset prices (bubble bust)	Markets sell-off intensified by heavy positioning, volatility increases	High
Oil	Oil prices increase above market tolerance	Tightening financial conditions, out of Central Banks control Inflation increase	High

Multi-Asset Portfolios

Top Down Views from Amundi Research

MONICA DEFEND, Head of Strategy, Deputy Head of Research
LORENZO PORTELLI, Multi-Asset Strategy

Moving towards a late-cycle financial regime

Central banks' "beautiful" normalisation of balance sheets and rates will drive the **transition from a reflationary into a late financial cycle regime** against a backdrop of consolidating growth (from both a macro and micro fundamental standpoint) and subdued inflation. The global economic recovery is not yet complete and accommodative monetary policy is still needed to allow policy implementation, support activity and eventually boost inflation. Benign economic conditions eventually passed through global EPS growth. In 2017, the recovery in global profits has been strong and well spread across regions. Based on our projections, we expect global EPS growth to consolidate around 10% on average. We think that the different stance of the EPS cycle is a good marker for our mid-term equity allocation. In the US, limited pressure on wages has underpinned margins while the dollar's overall depreciation in 2017 allowed some further momentum in the most recent reporting season. We expect US EPS to post around 10% year-on-year growth (tax reform excluded). The catch-up recovery in European profits will be supported by the expectations of higher rates and curve steepening, benefiting the financial sector in particular. EM earnings will eventually bottom out; Japan is surprising to the upside on tangibly improving fundamentals, independent from the yen (which, however, remains crucial).

In absolute terms, valuation on fixed income and equity are stretched on average. Global markets have, in fact, already priced in a good chunk of economic improvements. Opportunities need to be exploited on a country, style and sector basis to find pockets of value. However, we expect equity multiples to hold firm if the lift in interest rates is smooth and contained, and profits continue to consolidate, as typically occurs during a late financial cycle regime.

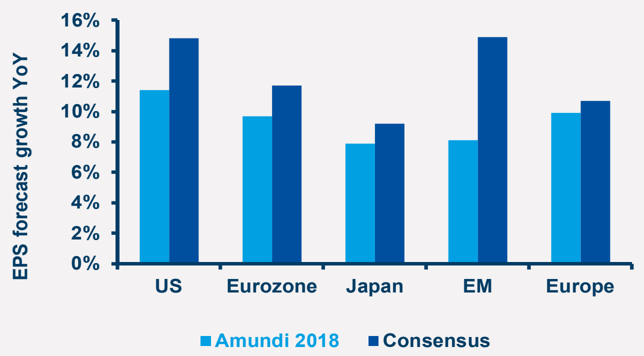
The **risk premia** on IG and HY credit are well above the historical average due to the impressive spread compression and low carry, which should eventually allow some rotation from HY into equity. Unprecedentedly low interest rates are keeping relative value considerations in favour of equities vs govies. On the latter, the extraordinarily low rate environment leaves fixed income vulnerable as the small coupons imply severe initial conditions should a bond bear market start.

Positioning and flows are key tactical factors that will influence and magnify the markets' correction. At present, while there has been a re-positioning out of global equities, fixed income and high yield in particular are crowded trades.

Cross asset: expecting lower risk-adjusted returns

As said, we expect a smooth transition from an asset reflation regime towards a late financial cycle. 2018 will be characterised by Central Banks (CBs) progressively removing their excessive accommodation, smoothly reducing global liquidity conditions while maintaining accommodative financing conditions and eventually lower risk-adjusted expected returns. The regime we will move into could be unique and unprecedented for the macro and financial conditions described in the previous pages. As a result, risk/return combinations will be lower than for similar past late cycles

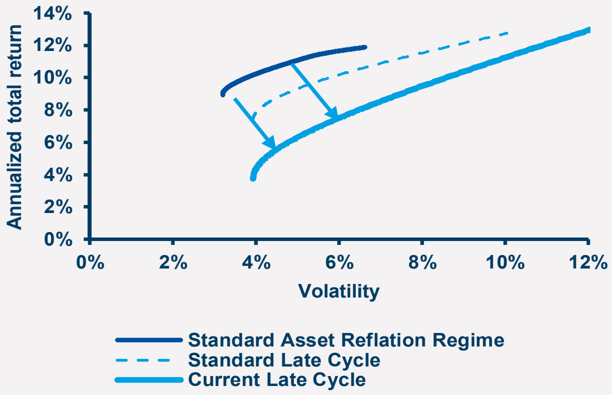
1/ **EPS growth 2018 projections**



Note: the chart shows Amundi Research's forecast yoy EPS growth for 2018. Consensus refers to the S&P500 website for US and FactSet for the other equity markets. Operating EPS S&P500, Eurostoxx trailing EPS, MSCI Japan LTM EPS, MSCI GEM EPS, and Stoxx Europe trailing EPS are considered for US, Eurozone, Japan, EM and Europe, respectively.

Source: FactSet, S&P, Bloomberg, Amundi Research (see the comparison with the "standard" late cycle frontier and the "current" one in the chart). In general, we expect volatility to increase moderately from the current compressed levels, but to remain on average low if liquidity provisions remain adequate.

2/ Efficient frontiers in different regimes



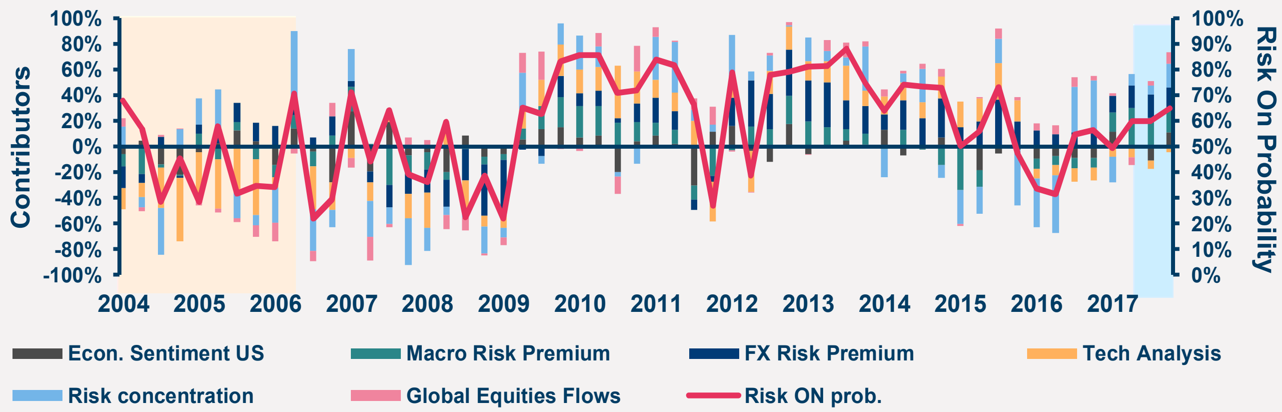
The Chart compares three efficient frontiers and plots the risk and total return profiles of 200 efficient cross asset portfolios (with different allocations optimised by volatility levels) for each frontier. The standard asset reflation frontier is calculated on historical average yearly returns and a covariance matrix specific to a previous asset reflation regime characterised by significant unconventional CB intervention (QE). The Standard Late Cycle frontier is calculated on historical average yearly returns and a covariance matrix during the Late Cycle regime. The Current Late Cycle frontier is calculated taking into account current bond and dividend yields. Asset class universe (local currency): US equities total return (S&P 500), US and Euro govies (JPM), US and Euro IG (ML), US and Euro HY (ML), GEM bond (JPM), US IL all maturities (Barclays).

Source: Bloomberg, Amundi Research

As a consequence, in order to enhance performance while keeping risk under control, in our view, it will be key to focus on selective opportunities and relative value trades (in preference to directional positioning) within and across asset classes.

In particular, from a cross asset perspective, **fixed income** is the asset class with a lower appeal. In fact, the risk attached to it when all our investment spectrum is considered is asymmetric: the expected gradual increase of interest rates will not be offset by coupons that are on average low. For these reasons, it is important that the asset allocation in fixed income is based on regional diversification and flexible duration management. CPI gaps and markets mispricing provide profitable opportunities in the inflation linkers space – in Europe in particular. Moving into the **risky assets**, a **rotation from HY into equity** is justified by the risk premium and the valuation reasons mentioned. The carry trade return component supports the case for **credit vs govies**, particularly where the CB purchasing programme offers good support. US and European companies are at different phases in their respective credit cycles. Our preference is for European investment grade, as there is no evidence so far of re-leveraging of non-financial European companies while leverage in US companies is very high.

3/ Amundi risk-on/risk-off indicator



Note: This proprietary indicator tracks risk sentiment and projects the probability of a shift between risk-on and risk-off regimes, and identifies the expected prevailing regime as the one with the highest probability. The indicator considers: the correlation among a risk-sensitive basket (S&P 500, VIX, Gold, JPY/USD and CHF/AUD); the Credit Risk Premium (Moody's calculation); the FX risk premium (BofAML calculation), the US Economic Sentiment Indicator (Citi Surprise index); technical analysis (Amundi calculation); and Global equities flows (State Street). The signal provides the probability of staying in a risk-on or risk-off regime. The expected prevailing regime is the one with highest probability.

Source: Bloomberg, Amundi Research

On fundamentals and valuation considerations, we favour **the equity markets of European countries, Japan and some relevant EM (in Asia in particular)**. In particular, Europe and the financial sector should benefit from rising interest rates and steepening of the interest rate curve, while Japanese companies should continue to benefit from a weak yen and the BoJ's equity purchasing programme. The most appealing equity region in EM remains **Asia,** with some interesting long-term stories based on improving internal and external conditions (China, India, South Korea, to mention the most relevant). At the same time, in such a mature phase of the cycle, an interesting equity theme to play is **quality with a focus on potential liquidity issues in an environment of (smoothly) rising interest rates**. For the same reasons, another important theme to consider is value in order to diversify regional equity allocation. **FX** will likely remain the most reactive asset class to CBs and to political noise while some trends are likely to continue (weak GBP, JPY). The USD should be considered for diversification and possibly hedging purposes.

Search for macro hedging

Expected higher volatility, unprecedented fixed income vulnerability, overcrowded fixed income trades, and a potential liquidity drain make the search for hedging a crucial factor in an environment in which inflation and/or rate surprises are flagged as major risks moving forward. 2017 stands as one of the longer lasting "risk on" periods relying on CB support. Moreover, it is worth noting how well balanced the contributions to risk on are at present, both from the real economy and the financial markets (i.e., economic surprises and macro momentum, credit and FX risk premia, safe haven asset class correlations). Moving forward, we expect this to change and more risk on/risk off switches to occur. In fact, during stress events, the interaction among risk factors usually tends to increase and the correlation between asset classes to lift while liquidity dries up. A good historical reference is 2004-2006, when the Fed became less accommodative (see graph below on the evolution of the risk on/risk off indicator).

In such an environment, the risk/reward profile has to be recalibrated, focusing more on limiting potential drawdown mainly through optionality, beyond traditional macro hedges, as they might not necessarily work (ie, the USD over the last year).

The risk of twin bear markets involving fixed income and equities with snowballing and painful effects on all financial and capital markets limits the set of potential and traditional hedging strategies and increases the cost of protections at the same time. Consequently, active hedging allocation management is worthwhile in the absence of a real diversifier, such as govies. In our view, liquid hedges, such as gold, and risk-sensitive cross rates, including the AUD/JPY, remain among the most effective macro hedging strategies in terms of costs and benefits.

CIOs' investment strategies: Q&A

MATTEO GERMANO, Head of Multi-Asset

Q1 / What are the key themes for multi asset investing in 2018, and how should investors play them?

We believe that in 2018 the key themes for multi-asset investing will remain broadly the same as in 2017, but with a different tilt and different implications on asset allocation. **Central bank asynchrony** will continue to unfold, with the Fed (and the BoE) on the tightening side, and the BoJ and ECB still broadly accommodative, but with adjustments likely. Therefore, investors should continue to reduce spread duration while maintaining credit exposure for carry trade reasons, and keeping average government bond duration short. In credit, investors should focus on IG vs HY, with a preference for the eurozone while it is still supported by the ECB's purchasing programme. We think inflation will be a key theme for 2018 amid a market that is sceptical in its expectations and commodity prices on a mildly rising trajectory. For us, this means favouring real vs. nominal rates with a focus on Japan, US and European inflation linkers. Another important theme we have identified is the **paradigm shift** (from monetary to fiscal policy). Regarding this, we believe investors should see more inflation catalysts to further increase the commitment to the performance laggards (Europe) that seem more sensitive to yield curve steepening. In Europe, financials could still offer opportunities, as the sector could benefit from the lack of interest rate steepening on the continent. A commitment to Japan should be maintained, with a progressive move towards a more selective approach in order to reflect the partial closure of the valuation gap and a positioning strategy which is less exposed than a few months ago. On EMs, we continue to see as beneficial a country-specific approach to identify stronger vs. weaker players and to take advantage of the different macroeconomic transition speeds. In our opinion, playing the entire EM complex seems like a potential mature trade in the presence of a strengthening USD and the perspective that rates will likely increase. Among EMs, we have positive views on South Korea and Russia given the backdrop of a solid macroeconomic situation. China is a theme investors should keep playing with a dual approach: as a relative value story, playing the progress of internal reforms and economic rebalances (New China vs Old China sectors), and given a directional focus, being aware of the increasingly stretched valuation conditions arising from the 2017 rally and macroeconomic variables that look to have peaked already but that remain supportive. We would suggest remaining liquid on quality names in EM bonds, preferring, when possible, carry trades in FX EM which look to be a more liquid proxy vs. cash bonds.

Q2 / What are the major changes that multi-asset investors should apply to their 2018 strategy compared to 2017 and why?

We believe investors should more intensively play country/sector/style and asset class/approach rotation during 2018. On style and sectors, we would focus on a rotation back to value in case of positive inflation and term structure evolution (steepening). On asset classes, we would look at a rotation towards equity vs. HY, which is experiencing a leverage increase back to 2008 levels and now appears vulnerable to interest rate rises (especially in the US). In terms of investment approach, we would focus on a rotation towards relative value trades to exploit different speeds in economic and policy adjustments, with a stronger focus on measures to tame rising volatility, liquidity and credit risk. On equity, our strategy would mean progressively replacing cash equity with an asymmetric option strategy, where we are keen to give up some participation in exchange for more protection.

Q3 / What are the main issues/events to watch during the year and why?

We think one of the key variables to look at will be US short-term real rates (see chart). This variable is extremely important as a barometer for the correct functioning of a leveraged credit market (HY more than IG in the US) and of equity markets. The US equity market has been largely driven so far from buybacks that seem to dry up when credit markets experience difficulties.

Outside the US, we believe it will be important to monitor producer price index (PPI) dynamics in EMs – more specifically, in China – because they can help in understanding price dynamics in DM as well. We monitor EMs' equity resilience, which critically depends on the level of the US dollar and ample liquidity.

Q4 / In your view, what are the biggest opportunities and risks not priced into the market for the new year?

In this last phase of 2017, a wave of limited inflation printing and cautiously dovish news from central banks have to a large extent favoured a further flattening of yield curves, preventing real rates from continuing to see a rising trend. Oil prices have been rising, but without noticeable effects on inflation expectations as measured by breakeven rates. In this environment, some equity markets, such as those in Europe, which are highly exposed to financials and industrials, have slowed more vs Japan and the US. European equities and financials specifically can deliver positive surprises if and when a mild but steady reflation process will be back in focus, driving the long end of the yield curve higher. We expect this to be in focus in 2018 with an increasing likelihood of seeing a transition to a late cycle. Among the risks not priced in by the markets, we would mention liquidity and credit risk.

These are clearly connected to each other, and both are associated with very low volatility. Structural changes in liquidity providers with banks deleveraging their balance sheets are largely untested, with investors' portfolios still extremely long income-seeking positions. A faster-than-expected increase in real rates could generate a market selloff in a fragile environment in which risks and asset classes will likely prove closely interconnected.

Q5 / And what strategies should investors apply to mitigate risk in 2018?

A rise in volatility from extremely suppressed levels seems likely in a year of contractions in central bank balance sheets and rising rates (the Fed). We expect to see a resurgence of liquidity as well as – especially in the US – credit risk. To mitigate this risk, investors could use different strategies: raise the liquidity profile in their portfolios; improve the average credit rating; maintain a commitment to a risk on stance, but progressively adopt option structures rather than cash equity; implement hedging strategies.

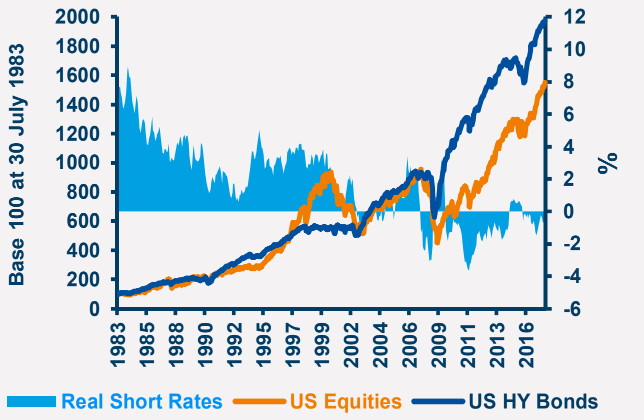
On hedging strategies, we believe that gold could work well when real rates dynamics give mixed signals regarding asset reflation vs the late cycle. The AUD/YEN could prove to be an efficient hedge if China were to start showing signs of a slowdown in growth and a PPI reversal. We would continue to play the USD/EUR as a safe haven in case of a market selloff or to counter geopolitical risks. We believe that at the current level of spreads and leverage, some hedging strategies on US HY spreads could be helpful in case of a market selloff.

Leveraging on the outcome of our Internal Risk Survey that compares the probability of occurrence and the impact on the implemented strategies, we believe investors should hedge the following risks:

- Market sell-off;
- Synchronised normalisation of Central Banks leading to lower liquidity, initial spread widening and a cross asset sell-off;
- Geopolitical tension from Brexit to Middle-East and North Korea/China/USA.

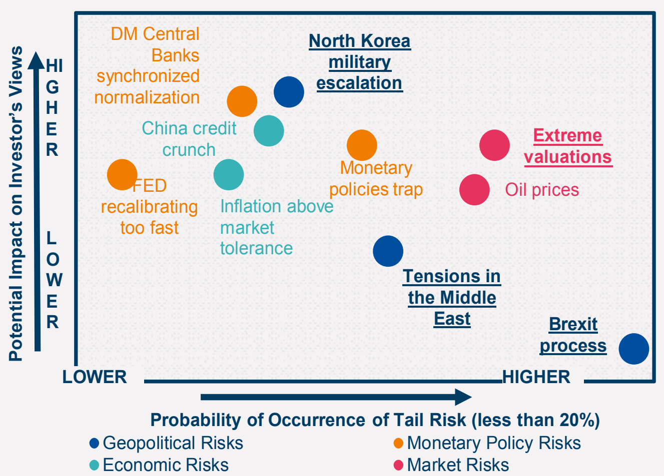
RISK	MARKET IMPLICATIONS	LIQUID MACRO HEDGES
• Boom bust bubble (i.e., market sell-off)	• Sentiment reversal initiates a decoupling of fundamentals and asset prices whose dynamics are magnified by heavy out of equity re-positioning (mainly from ETFs)	• Equity & FX optionality (AUD and JPY)
• Synchronised and too fast normalisation	• Lower liquidity, spread widening, fixed income sell-off, competitive devaluations and GEM asset classes under pressure. EM (bonds) outflows	• Optionality (CDS (HY)
• Geopolitical Tensions	• From regional (Brexit, Middle East) to global (North Korea/USA/CHINA)	• Long gold

1/ US real short-term rates, US equities and US HY



Source: Bloomberg, Amundi Research. Data as of November 10, 2017

2/ Amundi Top-Down Risk Matrix



Source: Amundi Research. Data as of November 10, 2017

Underlined risks are those hedged by Multi-Asset. Diversification does not ensure a profit or protect against a loss

Fixed Income and FX Portfolios

Top Down Views from Amundi Research
Government Bonds

BASTIEN DRUT, Fixed Income and FX Strategy
SILVIA DI SILVIO, Fixed Income and FX Strategy
ROBERTA FORTES, Fixed Income and FX Strategy
ABHISHEK GON, Fixed Income and FX Strategy

Developed Markets government bonds

In 2018, we expect long-term rates to rise in the US and Germany by more than currently indicated by the forwards. One argument behind this view is that the support of Central Banks' quantitative easing[1] policies will definitely be less intense than was previously the case, as the ECB will purchase fewer sovereign bonds than in 2015-17 and the Fed will not reinvest $252bn of US Treasury securities in 2018 (and around $360bn in 2019). While the net issuance of long-term eurozone sovereign bonds after ECB purchases has been negative at around €500bn in 2017, this quantity should only account for approximately -€60bn in 2018.

As far as the slope of the yield curve is concerned, we have two distinct views, as we expect the curve to steepen in Germany and flatten in the US.

A continuation of the steepening trend in the **German curve** (in the 2Y-10Y segment) is supported by the following:

- The Bundesbank continuing to purchase relatively short maturities;
- The Eurosystem's holdings of German securities, considered in 10Y equivalents, which are expected to stagnate or even fall in 2018 (depending on the timing of Public Sector Purchase Programme (PSPP) reinvestments and the share of the PSPP within QE in 2018);
- EUR short-term rates remaining broadly anchored by the ECB's forward guidance and not expected to be driven up by rate hike expectations during the first half of 2018 at least;
- Despite the ECB's reasserted forward guidance, expectations of some build-up on term premiums as the ECB is gradually engaging in policy normalisation and inflation is expected to increase gradually.

Our target for the 2Y rate is in a -0.40% to -0.20% range, with the 10Y rate at 1% by the end of 2018.

The **US yield curve** is expected to flatten (particularly in the 5Y-30Y segments) as:

- The front end looks more likely to sell-off than the back end, as the Fed is expected to hike at least twice in 2018;
- US 2Y-10Y could potentially flatten further from current levels; if some form of fiscal relief is delivered, with a boost to growth and inflation, the Fed could consider hiking a third time in 2018, overcompensating for any lift in the 10Y segment;
- Historically, the yield curve has flattened during Fed rate hike cycles.

Our targets see the 2Y rate at 2.10% and the 10Y rate at 2.70% by the end of 2018.

For Europe, we generally have a **broadly positive view of peripheral bonds**, as the ECB's PSPP will remain very supportive. On top of the still-significant Eurosystem bond purchases, the increasing deviations from the capital key rule will benefit French, Italian, Belgian and Austrian bonds more and more, and the maturity of Eurosystem purchases will remain higher for peripherals than for the purchases of German securities. Another argument in favour of peripherals is the cycle of re-rating of these countries (very recently, Italy and Portugal were upgraded by S&P and Ireland by Moody's). Regarding this segment, political risk remains the key issue: in particular, the Italian general elections will have to be monitored closely and may cause temporary widening of sovereign spreads. That said, the approval of the new electoral law is lowering the risk of a M5S-led government, as the electoral system has become more proportional and should favour the formation of coalitions, which M5S is completely against.

We have a constructive view on **inflation-linked bonds in Europe**. We expect eurozone inflation break-even rates to "normalise" in 2018, as they are currently still at very depressed levels (the German 10Y break-even rate is still below 1.30%) and as we are relatively confident about the gradual rise in core inflation in the eurozone. On the other hand, while US inflation break-even rates are not far from fair value (which we see at around 2%), they represent

[1] *Quantitative easing (QE) is a type of monetary policy used by central banks to stimulate an economy by buying financial assets from commercial banks and other financial institutions.*

an interesting hedge in case of an unexpected acceleration in inflation.

UK: we do not believe that the BoE can really afford to pursue a real rate tightening cycle in 2018 and therefore we expect short-term rates to remain close to their current level. We have no strong conviction with regard to longer-term rates, although the expectation of weakening pressure on the GBP should keep inflation expectations quite elevated and, to a lesser extent, put pressure on the back end of the curve.

Japan: although we expect the BoJ to remain highly accommodative, the central bank might have to increase the current yield target on 10Y bonds slightly from the current 0% to around 0.10% in order to move gradually closer to the level of global yields.

Emerging debt, hard currency: marginally positive, but selection is key

In 2018, we expect the global macro environment to remain relatively carry friendly, supporting EM bonds. Improving fundamentals and limited downside from China and commodity price stability are expected to keep global volatility subdued. Despite the current widening in spreads, valuations in the EM hard currency space still look tighter based on fundamental factors. Moving into 2018, we expect spreads to widen further due to rising US rates and EM-DM growth differentials. We believe investors should prefer a relative value approach at the single country level, favouring countries with improving fundamentals, a credible reform agenda (Argentina, Egypt, Brazil), attractive valuations, and attractive risk-adjusted carry. We are not expecting massive capital outflows from EM hard-currency bonds even if DM central banks continue to tighten monetary policies and although the positioning in EM hard currency bonds seems a bit stretched. In addition, we see risks of aggressive Fed tightening and a significant fall in commodity prices as relatively low.

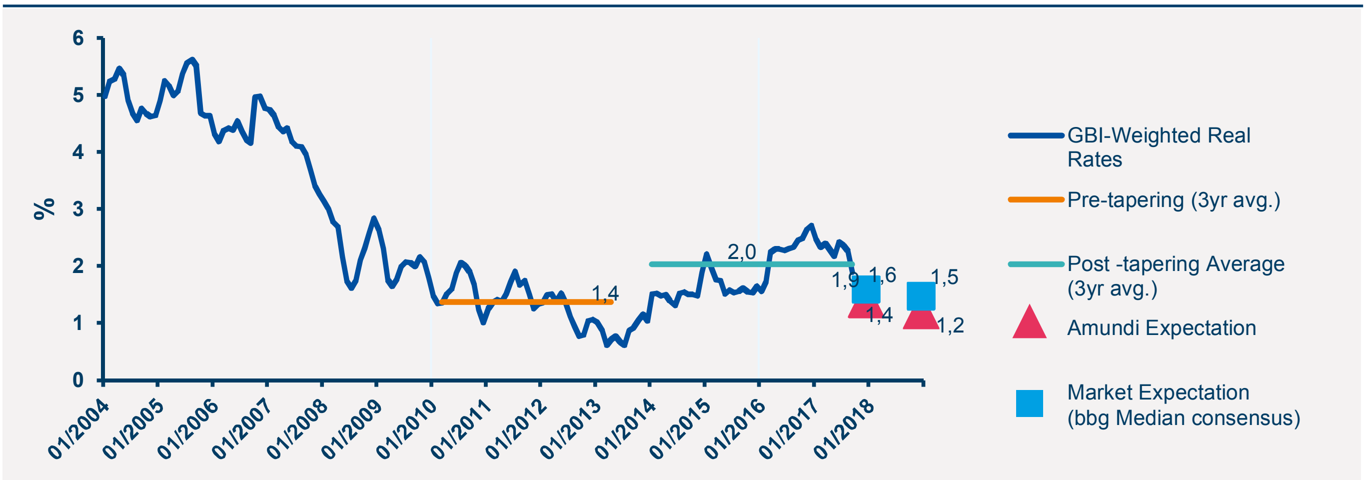
Emerging debt, local currency

Given our cautious view on EM currencies in 2018 (see the FX outlook), we have a neutral view on EM local currency debt, with an increased focus on selection. Our EM real rates model (GBI-EM global-weighted[2]) shows limited room for manoeuvre, as inflation in EM is likely to remain within the central banks targets (see chart below). EM FX valuations show limited upside over a 12-month horizon. We believe investors should focus on countries where sensitivity is low to the US 10Y yield in an environment in which US rates are increasing. Based on our analysis of the external vulnerability[4] index of EM countries, we prefer countries with low external imbalances. However, we think it is worth noting that since the first Fed tapering in 2013, most EMs (except Turkey) have adjusted their external balance sheets and, as a result of these adjustments, we might not see significant underperformance if US rates continue to rise in an ordinary manner.

Overall, we expect EM hard currency bonds to continue to outperform local currency bonds in 2018 in terms of spread compression. EM domestic fundamentals remain strong, attracting additional inflows, and the bulk of the underperformance of local currency bonds is expected to come from local currency depreciation, due to country-specific idiosyncratic event risks. Between the two asset classes (HC or LC), our preference remains towards high carry countries with improving fundamentals (growth, prudent monetary policies, and strong reform agendas), such as Argentina and Brazil.

[2] *GBI-EM Global Div is the most widely used index in the JPM EM Local Markets family.*

1/ EM Real Rates (GBI weighted)



Source: Bloomberg, Amundi Research, Updated as of November 10, 2017

Top Down Views from Amundi Research
Credit Markets

VALENTINE AINOUZ, Credit Strategy
SERGIO BERTONCINI, Credit Strategy

The dollar and euro credit markets recorded another year of very good performances, as follows: US IG (2.9% excess return vs government bonds, Euro IG (3.3%), US HY (4.8%) and Euro HY (7.2%). These positive performances have been supported by a broadly synchronised upswing in the world economy, highly accommodative monetary policies, and very low volatility. We believe that the credit markets will continue to benefit from this environment in 2018: global growth is positively oriented and the moderate inflation outlook is enabling the ECB and the Fed to gradually tighten their monetary policies. On the back of this rally, spreads are closing in on cycle lows, so the key question for investor is "what should we expect for 2018?".

Technical factors will remain supportive for credit markets

In our view, the US IG market will continue to be supported by the following:

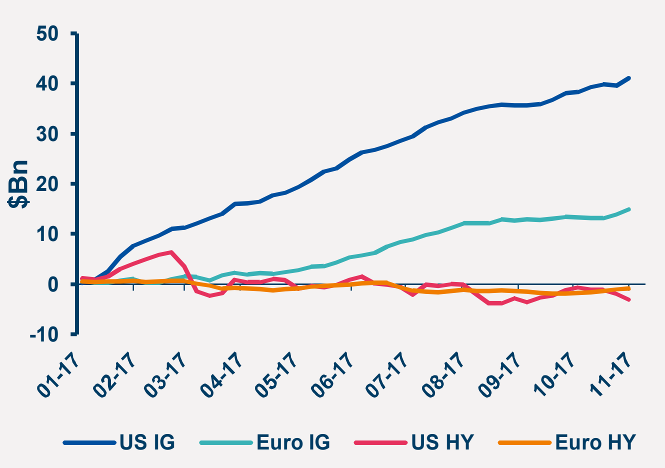
- **Strong inflows.** The demand from foreign investors has increased at an unprecedented pace in recent years. USD corporate securities held by foreign residents have increased by 45% since 2012 and currently account for 40% of the USD corporate bond market.
- **The slowdown in net supply**, after the peak reached in 2015 thanks to the recent decline in M&A and share buyback activity. American companies raised a record amount on the US IG market primarily to fund M&A and share buybacks. This market has virtually doubled in size since the collapse of Lehman Brothers.

US HY offers a different picture: market flows are relatively flat on an YTD basis, but the net supply has been negative over the past two years. Companies prefer to borrow on the loan market, as covenants have weakened. This trend is expected to continue in 2018.

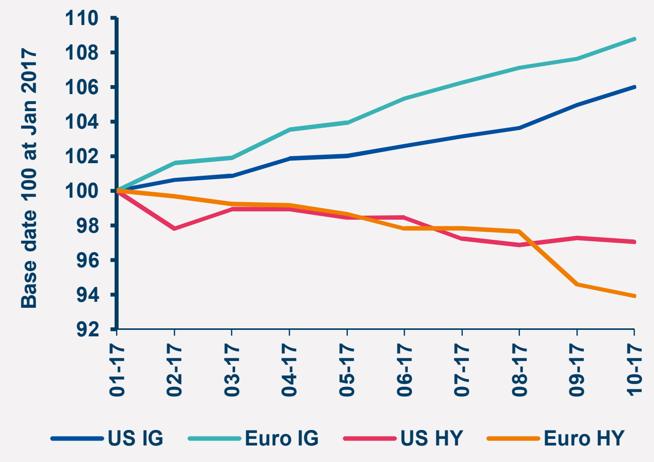
The Euro market will continue to be sustained by the following:

- **The search for yield.** The ECB will likely continue to keep sovereign interest rates under pressure in 2018 (negative net sovereign debt issuance after ECB purchases and rates will remain at their present levels for an extended period of time, in our view). The IG and HY markets should both benefit from this search for yield.
- **The "sizeable amounts" of ECB purchases.** Indeed, the ECB faces no scarcity issues on the corporate bond market, as could be the case on the sovereign and covered bond markets. Corporate Sector Purchasing Programme (CSPP) holdings amounted to €114bn at the end of September 2017, which represented only 13% of the universe of bonds eligible for the CSPP. We expect the ECB to purchase corporate bonds at a monthly pace of €3.5-4bn from January 2018 until the end of September 2018.

1/ **Cumulative Flows**



2/ **Trends in the size of the markets**



Source: Bloomberg, Amundi Research. Data as of November 15, 2017

- **Negative net supply on the Euro HY market** also offers support for spreads. As in the US, the loan market is cannibalising some issuance on the high-yield bond side. This trend is expected to continue in 2018.

Fundamentals are well oriented

The fundamentals of American companies should continue to improve in 2018. Most companies recorded a decline/ stabilisation of their leverage in recent quarters due to:

- **A positive trend in profit growth.** Sales growth was supported by positive global economic momentum, the recovery in the price of oil, and the good performance of the technology sector; and,
- **More cautious behaviour,** which is quite unusual at this stage of the cycle.
- However, the number of HY firms with very low interest coverage ratios remains high. Currently, one-third of companies seem to be in a challenging situation.

The fundamentals of European companies should remain in line with bondholders' interests. European companies globally have low debt. The recent acceleration of European growth has not led to massive M&A, share buybacks or large dividends.

Companies are in general fairly relaxed about their funding needs. Companies pushed the redemption wall out further as they increased their debt maturity profiles. US HY and Euro HY default rates are expected to fall further in the coming months. In particular, speculative-grade default rates should decrease to the 2.5-3.0% area in the US, while European default rates are expected to fall even more from already low levels to the 1.5-2.0% range.

On the back of the last rally, valuations appear tight

Our models show that although valuations look rich vs their underlying factors on both sides of the Atlantic, US credit spreads look more stretched than for EUR credit markets for both IG and HY, despite the ECB's direct support for European credit through the CSPP. Current yield and spread levels point to lower expected returns in the coming years (but this is a common theme throughout the fixed income world).

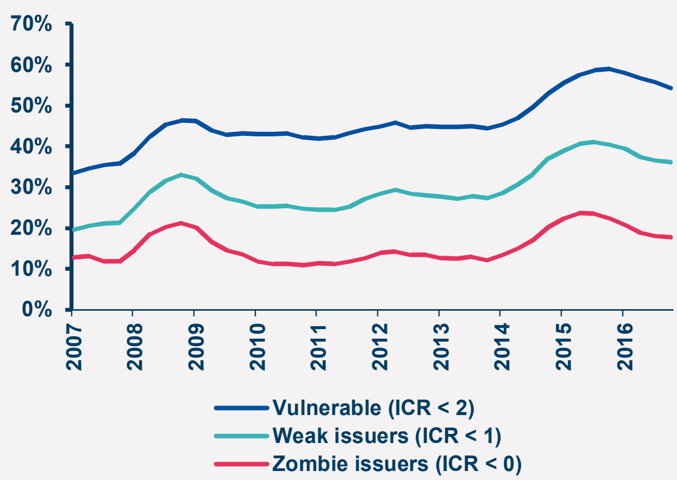
In terms of curve segments and sectors, we still prefer the few remaining "oases" in the European yield desert, especially in the 1-5-year segment of European yield curves: IG financial subordinated debt and speculative-grade debt, within this segment, remain almost the only suppliers of still positive, though limited levels of yield, therefore attracting investor flows over the next quarters.

While European credit markets – which are under the CSPP "umbrella" – offer an attractive risk/reward combination, especially in terms of lower volatility with respect to the past, US IG bonds, despite being relatively expensive in terms of valuations, offer quite an attractive absolute yield level in fixed income and balanced multi-currency portfolios.

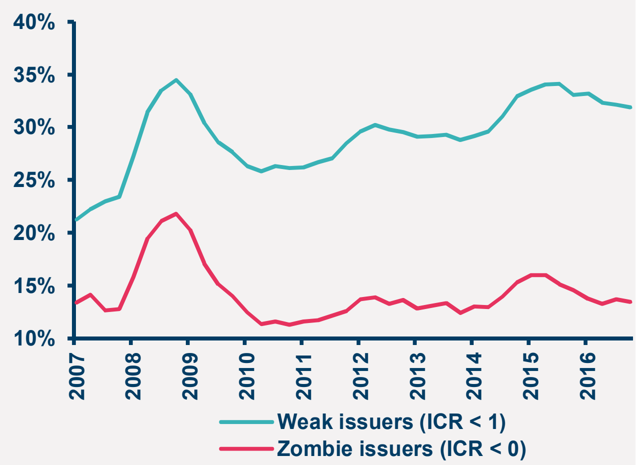
Within the HY universe, low-rated segments also look stretched in terms of the implied default rate. High- quality (BB-rated) HY spreads, on the other hand, still provide a bit of a cushion for credit events in both USD- and EUR-denominated debt: in the current low default rate environment (low yield, low growth, low inflation), BB-rated spreads still imply a default rate higher than historical long-term averages.

Our forecasts for 2018 credit spreads are: Euro IG: 90 bps, Euro HY: 260 bps, US IG: 110 bps, US HY 390 bps.

3/ **US HY**
Percentage of "challenged" firms



4/ **US HY (Ex. Energy)**
Percentage of "challenged" firms



Source: Bloomberg, Amundi Research. Data as of November 15, 2017

Top Down Views from Amundi Research
FX Markets

BASTIEN DRUT, Fixed Income and FX Strategy
SILVIA DI SILVIO, Fixed Income and FX Strategy
ROBERTA FORTES, Fixed Income and FX Strategy
ABHISHEK GON, Fixed Income and FX Strategy

EUR/USD

The continuation of a solid recovery in the eurozone paired with diminishing monetary accommodation from the ECB provides a positive backdrop for the single currency into 2018. Although its valuation gap with the USD narrowed over 2017, the EUR is still cheap versus the USD, providing fundamental support. The reduction we expect for the 10Y rate differential between the US and Germany should cut the attractiveness of the USD versus the EUR on a carry basis. The upside potential to EUR/USD rate should, however, be limited by both the dovish quantitative easing recalibration by the ECB for 2018 and the prospect of a tax cut in the US.

The political agenda for 2018 is much lighter than 2017. Risks are concentrated around general elections in Italy by the first half, regarding which we could see long EUR positions being hedged ahead of the event.

On the positioning side, we believe this year's real money investors' shift from the USD into the EUR could remain in place, as an overall accommodative monetary policy stance should keep investors' risk appetites upbeat and favour the continuation of flows into European equities, thus offering the EUR an additional tailwind.

Our target for the EUR/USD rate in H1 2018 is 1.15-1.18. In H2 2018, we could see appreciation of the EUR versus the USD towards 1.22.

USD/JPY

Monetary policy will continue to be supportive for FX, as the BoJ is expected to remain very accommodative in 2018. The JPY has scope for further depreciation, in our view, both versus the USD and the EUR, due to gradually rising long-term yields in the US and in Europe versus 10-year yield targets maintained at around 0% (as per the BoJ's "Yield Curve Control"). Rate differentials will therefore remain the main driver of the exchange rate. However, we do not believe that the JPY can depreciate too much, as on the one hand, the currency is already sharply undervalued and, on the other, a substantial rise in global interest rates might prompt a reaction from the BoJ, which could have to raise the 10Yr yield target as a consequence. Approaching 120 for the USD/JPY would, moreover, exacerbate accusations of currency manipulation from trade partners.

Positioning on the JPY from institutional investors has been skewed to the short side during 2017, and barring any spike in geopolitical risk or material changes to the BoJ's stance, it is likely to remain in the current bearish range.

Our target for the USD/JPY rate is in the 115-118 range by the end of 2018.

GBP/USD

Our expectations regarding the UK economy are for an extended GDP weakness into 2018 on the back of the uncertainty over Brexit negotiations, weighing mostly on investments. In such a fragile backdrop, we believe the BoE will struggle to hike rates further in 2018. News flow on Brexit negotiations remains crucial and the GBP will likely be quite volatile and trending lower, versus both the USD and the EUR. Risks are related to a benign scenario in discussions with the EU: the achievement of a transition agreement would in fact postpone the materialisation of any impacts for the UK due to its departure from the EU.

Our target for the GBP/USD rate is in a 1.26-1.28 range by the end of 2018.

EM FX

A supportive global backdrop for EM FX was in place for most of 2017, as a strong rebound in global trade, benign global rates, positive growth surprises from China, and a weaker USD helped EM FX to outperform until the summer. However, since September, these tailwinds have been fading and, looking forward to 2018, we have a more cautious view on EM FX as an asset class.

We expect the USD to remain broadly weak, but not to depreciate to the same extent we were expecting at the beginning of 2017. EM-DM growth differentials are expected to flatten out or marginally increase into 2018, as the global growth acceleration is shifting from China to DM or to other EM. Incremental EM export volumes are cooling after extremely strong growth in Q1 2017 (base effect). We do not expect a significant commodity price rally to drive EM FX next year.

This is a key component to capital flows into EM. The differences between local and DM rates are expected to narrow, supporting hard currencies.

From the perspectives of EM central banks, we expect less of an easing bias in 2018. Based on our Taylor Rule[1] and macro assessment, we expect EM rates for 2018 to be determined mostly by output gaps, not by inflation gaps, as inflation in most EM (except Turkey) is likely to stay within central banks' targets. Moreover, we expect EM central banks to continue to accumulate FX reserves at least to 2013 pre-taper levels as EM inflation (broadly) should remain low and within CB targets. Lastly, uncertainty regarding US tax reforms and risks from rising US rates could represent key triggers for an EM FX sell-off, and the busy political calendar in many EM will add more volatility in 2018.

Notwithstanding these issues, there is still room for being selective on EM currencies, with a focus on high-yielding EM FX, where carry is still attractive. Short-term valuations look a bit stretched, according to our valuation models, but on a medium-term basis, there should still be enough room for selective EM FX to appreciate. We continue to prefer relatively cheaper high carry/low volatility currencies of the less externally vulnerable countries, such as the Indian rupee and South Korean won.

[1] *The Taylor rule give indications on how central banks should adjust short-term interest rates in response to inflation or output gaps.*

CIOS' Investment Strategies: Q&A

Global Bond Investment Outlook

ERIC BRARD, Head of Fixed Income
LAURENT CROSNIER, Head of Global Fixed Income

Q1 / How do you believe investors should play the 2018 investment environment in terms of positioning and risk budgeting?

We are observing a major discrepancy between the signals sent by the performance of risky assets (credit, equity, EM debt) and those coming from the sovereign bond market. We can still see the repression on the bond risk premium coming from CBs with yields at their lowest historical levels.

In this environment, we believe investors should favour a reduced duration exposure on G4 government bonds, especially on Germany and Japan, where valuations are still at very stretched levels and do not reflect the synchronised global growth recovery and the monetary policy normalisation in progress.

For global fixed income investors, in 2018, most of the risk budget should be deployed on relative value strategies, in our view, with five high conviction ideas:

1. Inflation linkers vs nominal, favouring an inflation break-even exposure;
2. US vs Euro rates, pointing at a spread tightening between the two yield curves;
3. Yield curve management, focusing on the US yield curve flattening and on the flattening of the Euro curve in the 10-30Y bucket;
4. EM vs DM, preferring long EM debt;
5. Dynamic spread management, with a preference for hard currency EM debt, credit and peripheral countries.

Q2 / How should the investment approach change in 2018 compared to 2017 and why?

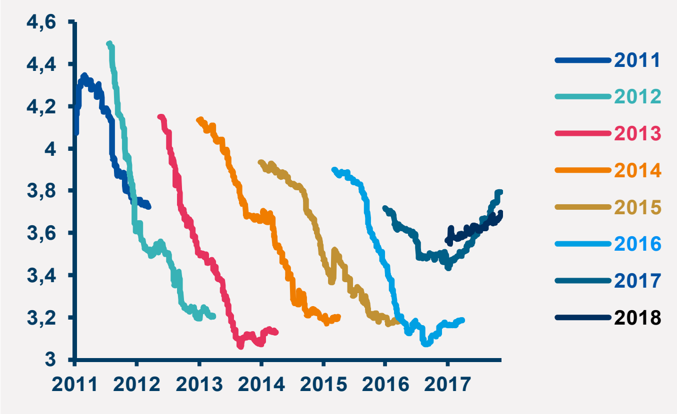
The valuation levels and divergences in adjustments of CB policies as well as some volatility in the macro data and tension in the geopolitical landscape, in our view, call for a stronger focus in 2018 on relative value strategies and volatility hedges in global fixed income.

Q3 / What are the main issues/events to watch during the year and why?

We see five factors to watch in 2018. First, on the macro side, the evolution of the inflation outlook, and in the US, the job market (non-farm payroll). Regarding the US, it will also be important to assess President Trump's policies – in particular, potential tax reform: how and when it will be implemented could drive movements in rates. Among the other issues to watch, we focus on the Chinese outlook and how Chinese authorities will manage the slowdown, and the commodity outlook (also considering the recent rise in oil prices and tensions in the Middle East).

In Europe, the main events that could affect the global fixed income markets are the Italian elections (in the spring) and how the Brexit negotiations unfold.

1/ **World real GDP growth forecast**



Source: Bloomberg, Amundi Research. Data as of November 15, 2017

2/ **Possible surprises to watch for in 2018**

Positive Surprise	Negative Surprise
• Tax reform	• Surge in Inflation
• Hard Brexit	• Italian election
• EM growth	• US slowdown

Q4 / In your view, what are the biggest opportunities and risks not priced into the market for the new year?

We believe that the markets still underestimate the possibility of an acceleration in inflation and of a faster normalisation of CB policies. Thus, we view an underweighting of duration exposure in Japan, core Euro and the UK and an overweighting of break-even inflation as appropriate strategies in this market. In addition, credit should remain mildly supported vs govies in global fixed income, with a focus on quality and liquidity provided by the investment-grade segment. Regarding EM bonds, we still see some areas of value in local currencies, where selection will remain key.

Q5 / And what strategies do you suggest to mitigate risk?

To mitigate risk, investors could implement a combination of strategies: an exposure to the US dollar, reduced duration to core markets, and exposure to option strategies with a view to benefitting from a rise in implied market volatility.

European Bond Investment Outlook

ERIC BRARD, Head of Fixed Income
MARIE-ANNE ALLIER, Head of Euro Fixed Income

Q1 / How do you believe investors should play the 2018 investment environment in terms of positioning and risk budgeting?

A combination of low inflation, strong growth, very accommodative monetary policy and favourable liquidity conditions suggests, to a certain extent, a positive investment environment for bond investors. We are aware that valuations are not historically attractive, and we also think that they could remain expensive for some time. In the meantime, however, there will be plenty of opportunities for active, flexible investors to generate alpha[1].

We like the credit market. In particular, we believe investors should remain overweight on financials versus industrials, and subordinated versus senior debt. This view is for 2018 overall, as the ECB gave comfort on the continuation of the Corporate Sector Purchasing Programme (CSPP). We believe investors should be underweight on core rates, but with a low risk budget.

Duration exposure will not be a key axis at this point in the cycle. On peripheral bonds, we believe investors should be progressively moving from an “overweight forever” approach to more dynamic positioning. At this level of spreads, political and economic developments will probably offer more volatility – hence, more opportunities to be under/overweight.

Finally, the specific part of the market that has not priced in a recovery story is the inflation-linked segment. That’s why we believe investors should favour inflation-linked bonds versus nominal bonds – at least until valuations recover.

Q2 / How should the investment approach change in 2018 compared to 2017 and why?

A strong focus on fundamentals with a very flexible approach to fixed income will be key in 2018, as it has been in 2017. We are conscious of expensive valuations, low volatility and market positioning: hence, we believe that a tactical approach to investing will be very important to address market challenges. A good example of how to be tactical is in peripheral bonds. The political turmoil in Spain and the general election in Italy next year are market movers and we should see more opportunities in these relatively liquid markets going forward.

Q3 / What are the main issues/events to watch during the year and why?

In 2016 and 2017, the focus was on politics. We believe 2018 will be about central banks. The ECB in particular will be a key driver for bond investors next year. We think the negative repo rate contributed significantly to the compression in risk premia and volatility. As long as the normalisation of ECB monetary policy remains far off, a regime shift (in yields as well as in volatility) is not our central scenario.

Q 4 / In your view, what are the biggest opportunities and risks not priced into the market for the new year?

Inflation is the macroeconomic variable to watch. It is the biggest potential opportunity, as break even inflation[2] is cheap in the eurozone. It is also the biggest risk for the credit market, as higher inflation might force the ECB to implement a faster tapering process.

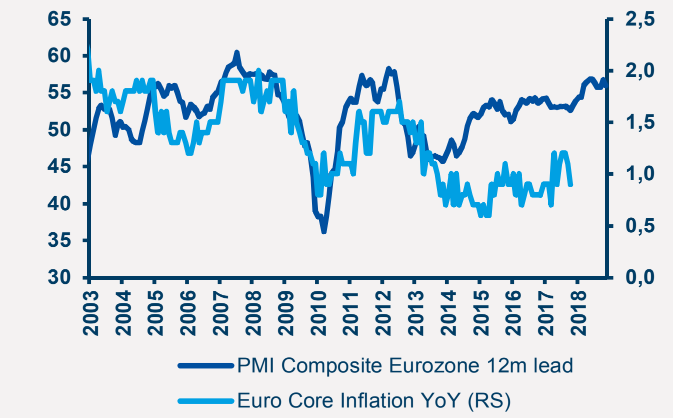
[1] *The additional return above the expected beta-adjusted market return; a positive alpha suggests risk-adjusted value added by the money manager versus the index.*

[2] *Breakeven inflation is the difference between the nominal yield on a fixed-rate investment and the real yield on an inflation-linked investment of similar maturity and credit quality.*

Q 5 / And what could be the strategy to mitigate risk?

With a positive view on credit, an overweight position on inflation-linked bonds could be a good hedge against the potential risk of a rise in inflation and a more hawkish ECB. Volatility trades could also be a good tool, in our view.

1/ **Eurozone core inflation and PMI**



Source: Bloomberg, Amundi Research. Data as of November 15,2017

2/ **Possible surprises to watch for in 2018**

Positive Surprise	Negative Surprise
• Inflation on the rise (relative performance) • Growth with subdued inflation to continue for an extended period • Big step forwards in eurozone integration	• Inflation on the rise (absolute performance) • Bad outcome for Euro politics • EM crisis

Japanese Bond Investment Outlook

ERIC BRARD, Head of Fixed Income
SHINICHIRO ARIE, CFA, Head of Fixed Income Japan

Q1 / How do you think investors should play the 2018 investment environment in terms of positioning and risk budgeting?

In 2018, we foresee moderate GDP growth, supported by stable growth in corporate earnings, a rebound in Capex, an increase in government spending for development/redevelopment of infrastructure, and far-below-target inflation. Based on this view, we don't expect to see significant changes in the corporate bond market or in the mortgage-backed securities (MBS) market, which we expect will be quiet and stable based on an unexciting housing market. Investors should favour a short-term credit ladder[3] portfolio of up to three years and a significant overweight (by more than 10%) in MBS with interest rate risk hedged. Based on our economic outlook, we don't expect a significant change in monetary policy.

While maintaining the basic structure of a yield curve strategy which consists of cushion positions, term structure positions, and mean-reversion positions, we believe investors should rotate the emphasis on positions from time to time to capture movements in the JGB (Japanese Government Bond) curve. It could be said that current monetary policy provides opportunities to generate stable excess returns through yield curve management, though the level of "excess" is gradually shrinking.

Q2 / What are the major changes in your investment outlook for 2018 compared to 2017 and why?

Based on our view of the market, as mentioned above, we don't expect to make any significant changes in our investment outlook in 2018, particularly as regards the BoJ maintaining its current monetary policy.

Q 3 / What are the main issues/events to watch during the year and why?

As the mandate of the current BoJ Governor Kuroda will end in April 2018, the market may have concerns about the continuity of the current monetary policy, which has been exceptionally accommodative since he took the role as governor. However, it is almost the market consensus that Haruhiko Kuroda will be reappointed as governor for another term. So, there is little expectation of changes being made to monetary policy early next year. However, as the economy grows and consumer prices continue to increase, albeit at a more gradual pace, the BoJ may be forced to review monetary policy by the end of 2018.

It is expected that the BoJ will make a slight change to the "Yield Curve Control" policy by adopting a wider range for the 10-year yield, which is currently contained in a 0-10bps range, or by changing the target maturity to be

[3] *A bond ladder is a portfolio of bonds in which each security has a significantly different maturity date.*

controlled from 10 to 5 years. Either change will affect the level of 10Y yields as well as the shape of the curve in at the longer end.

Q4 / In your view, what are the biggest opportunities and risks not priced into the market for the new year?

It is a widely shared view that equity markets are too stretched, not only in Japan. Global credit markets are also perceived as being "too rich". So, we may see a relatively large drop in equity markets, with the consequence that credit markets correct as well. Market correction itself should be negative for credit investment; however, a short-term credit ladder portfolio could outperform the market due to much shorter spread duration. Moreover, it may be possible to utilise any market correction as an opportunity to improve the credit spread profile of a portfolio by investing maturity proceeds into bonds with much higher spreads.

Q5 / And what could be a strategy to mitigate risk 2018?

In our view, investors should be most concerned about and aware of the liquidity of a portfolio's holdings. JGB are still very liquid, though they are now less liquid than they were five years ago. As the Japanese credit market is somewhat illiquid, we believe investors should focus on credit shorter than 3Y in duration to maintain a credit ladder portfolio up to 3Y, which may provide a steady cash flow, as redemption proceeds from corporate bonds are paid every two to three months.

1/ Shape of the JGB yield cushion*

Source: The yield book,Amundi Research. Data as of October 31,2017 (Yield cushion = Rolling yield/ Duration)*

2/ Possible surprises to watch for in 2018

Positive Surprise	Negative Surprise
• Small credit market crash	• Sharp increase in inflation
• Strong growth in housing market	• Sharp depreciation of the yen
• Increase in Samurai bond issuance	• Smoother shape of the yield curve implied by BOJ

US Bond Investment Outlook

KENNETH J. TAUBES, CIO of US Investment Management

Q1 / What is your outlook for the US economy and interest rates in 2018?

The team remains constructive regarding both US and global GDP growth. Within the US, solid employment may continue to support consumption, while the economy may also continue to benefit from higher corporate profits, reflecting improved global growth, easy financial conditions and lower regulation. The prospect for tax cuts has increased as well; that may further bolster corporate profits and the economy in 2018. While the market has now priced in higher expectations for a 2017 December rate increase, the market has priced in a 1.69% Fed Funds rate (early November) by the end of 2018, well below the median level of the FOMC (Federal Open Market Committee) projections of 2.13%. We believe the market continues to be "behind the curve" in its view on the appropriate level of interest rates. Despite the Fed's concern about relatively low inflation, we believe it will proceed with planned rate increases in 2018.

Q2 / What could be the impact of this outlook on fixed income porfolio construction?

Given the outlook above, we believe investors should continue to be positioned for rising interest rates and a solid economy. With a multisector fixed income approach, the focus should be on being overweight on diverse credit sectors and underweight on U.S. Treasuries. Most US government debt, we believe, is unattractive, while credit sectors may benefit from stronger growth, lower taxes and less regulation. In addition, a short duration position could be beneficial in a rising rate environment. We believe the market may be behind the curve, given solid GDP growth, little slack in the labour market, strong global PMIs, and an average inflation rate of 1.5-2% over the rest of the year and into 2018.

Given this view, another high-conviction idea is for long-duration TIPS (Treasury Inflation Protected Securities), as we believe that break-evens do not accurately reflect the longer-term potential for 2% inflation.

As valuations have become extended, a way to protect investors' fixed income portfolios is to reduce credit risk. Strong fundamentals – strong economic growth and the prospects for corporate tax cuts – are counterbalanced by stretched valuations. Total investment-grade corporate spreads stand at post-crisis lows, and reflect lower quality and overall longer duration relative to their historical levels. The valuation picture is more nuanced within the high-yield market. While spreads are low at around 350[8] bps, they remain well above their 2007 tights of 241 bps, although we believe the potential for further spread compression is more limited. Again, the fundamental outlook for the high-yield markets is positive, with strong economic growth, higher energy prices, and the prospect for tax cuts, although the proposed interest deduction limit could hurt more highly-levered companies. However, in light of extended valuations, it's important to progressively reduce high-yield exposure and upgrade the quality of this high-yield exposure while maintaining a positive bias to the market, given the greater opportunity to add excess returns from sector as well as security selection. Additionally, investors could have a neutral view to agency MBS (Mortgage-Backed Securities). Overall, including the focus to non-agency MBS, we believe that investors should remain positive on Residential Mortgage-Backed Securities. Agency MBS currently offer fair value, but can be used to upgrade the overall fixed income portfolio quality. In addition, fundamentals for the housing sector remain strong, given improving employment, still low mortgage rates, and still attractive home price affordability.

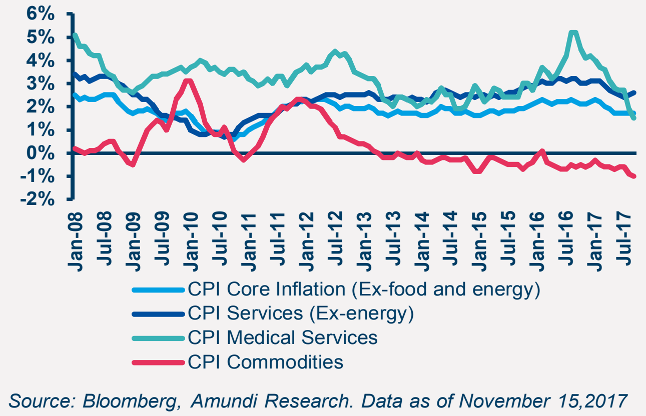
Q3 / What key developments will likely impact US fixed income during the year and why?

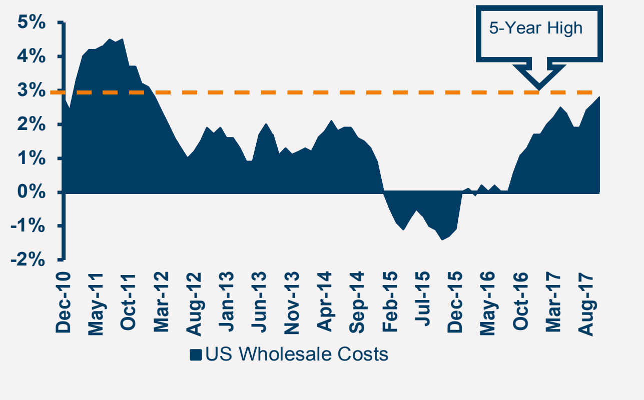
Central bank normalisation policies will have a meaningful impact on the US fixed income markets during the year. Given that the Federal Reserve is in the early stages of its balance sheet unwinding programme, investors will be closely monitoring its effects on the yield curve and the supply/demand balances in the US fixed income market. Additionally, the details and timetable of a potential ECB tapering programme later in 2018 will have broad implications for global interest rates, particularly given that the Fed's unwinding programme will already be well under way. The US political landscape will bear close watching, as tax reform could occur early in the year, which may add stimulus to the domestic economy and meaningfully impact corporate tax rates. The effectiveness of the Trump administration and the viability of its legislative agenda could potentially be challenged during the year by the ongoing special council investigation being led by Robert Mueller. Additionally, the outcome of the mid-term congressional elections and whether this leads to majority control by the Democratic party may become a key consideration to administration policy going forward.

Q4 / In your view, what are the biggest opportunities and risks not priced into the market for the new year?

Given both the strong domestic employment trend and GDP data, we believe the potential drivers of higher-than-anticipated inflation exist. Nascent signs of wage growth acceleration, service inflation, tighter labour markets in key industries such as home building, and more restrictive immigration policies may contribute to higher price levels in the coming year. The potential for tax reform also has the capability of providing an additional catalyst to inflation. We believe investors should be positioned for an uptick in inflation with short duration exposure while also allocating to TIPS. Additionally, given the positive underlying fundamentals of the residential housing market, which has been aided by the strong employment trend and lack of supply, a positive bias towards RMBS could be appropriate. A potential risk to monitor in 2018 is that while tighter corporate spreads and higher leverage are currently counterbalanced by strong fundamentals, a slowdown in global growth or a change in central bank policies has the potential to result in spread widening and/or volatility. To mitigate these risks, investors should consider a more cautious exposure to investment-grade and high-yield corporates.

1/ Key variable to watch: inflation





Source: Bloomberg, Amundi Research. Data as of November 15,2017

Year-over-year monthly percent change. CPI: Consumer Price Index, a measure that examines the weighted average of prices of a basket of consumer goods and services; one of the most frequently used statistics for identifying periods of inflation or deflation. US Wholesale Costs is measured by US PPI Final Demand YoY index

Q5 / And what could be the strategy to mitigate risk?

Limiting downside risk and avoiding permanent impairment of capital will be paramount in a world of stretched valuations. This can be achieved through a disciplined approach aimed at limiting issuer concentrations, combined with strong fundamental credit research, avoiding at-risk sectors, and avoiding market value loss in rising interest rate environments. We believe investors should continue to adhere to these core tenets as they look to mitigate risk in the coming year.

Emerging Market Bond Investment Outlook

MAURO RATTO, Head of Emerging Markets

Q1 / How should investors play the 2018 investment environment in terms of positioning and risk budgeting?

Our base-case scenario for 2018 looks for moderate mid-single-digit returns for hard currency EM debt and high-single-digit returns for local currency debt.

Emerging markets should continue to reward investor confidence through a combination of strong macro and corporate performance. This reflects in both current account surpluses and healthy margins in both the national and corporate sample. In the recent past, such conditions have been consistent with a material market deepening effect in both the hard and local currency arena. In our view, a continued market deepening theme will provide a positive backdrop for performance generation through security selection. As the only asset class globally to offer both real growth and real rates in fixed income, EM appears well positioned to continue to attract positive flows in 2018, thus potentially offering a year that at least initially reflects conditions visible in the second half of 2017. The year has been notable for steady inflows, as investors sought exposure to both the shorter duration and higher yields offered by EM bonds. Minus external risks, we think this may continue into the new year.

That said, inflationary pressure in EM appears to be moderating, leaving only a residual disinflation lever to local currency performance. Energy prices present a material risk to this view, especially in light of recent developments in a number of energy-producing countries, such as Saudi Arabia, Venezuela, Iran and the Kurdish region. In our base-case view, we expect moderating energy prices to contribute to a general easing of financial conditions.

Q2 / What are the major changes in your investment outlook for 2018 compared to 2017 and why?

External challenges may play a larger role in 2018. This is because of the increasing importance of the economic recovery that is becoming more visible in both the US and Europe. EM activity is highly sensitive to exports; hence, demand increases from both the developed world and China can have a material impact on performance. EM spreads remain tight vs historical averages, reflecting higher investor expectations regarding global growth. In turn, this global growth expectation appears to be a second derivative of a US economic recovery.

This apparent dependence on a US economic recovery points up the timing of potential US tax cuts as both a catalyst and central risk to EM performance in the new year.

Should the Trump administration succeed with material tax reform, we expect the resulting increase in activity to support the Fed's case for further tightening. This may continue to support a view of short duration.

Q3 / What are the main issues/events to watch during the year and why?

We continue to look for evidence of continued growth recovery in the developed economies, as this is reflected in a positive demand backdrop for emerging markets. EM growth tends to be reflected in services, which then shows in returns. At a local level, inflation and financial condition indexes should provide insights into domestic economic performance, which potentially will offer insights into local activity levels. This matters across most countries, but is arguably critical for higher-risk countries.

As rates in the developed world begin to creep higher, we think selection will become more of a performance differentiator. The ability to avoid issuers with weaker fundamentals compared to their peers will help mitigate negative performance contribution. 2018 will be a year of elections in Latin America, with Mexico and Colombia potentially swinging to the left. This may be reflected in higher domestic yields, which in turn potentially presents an opportunity. Lastly, geopolitical tension could be reflected in more volatile energy prices. It is always a good idea to keep an eye on oil prices.

Q4 / In your view, what are the biggest opportunities and risks not priced into the market for the new year?

EM have generally performed well for fixed income investors over the last three years, and we think 2018 could offer another year of positive returns. However, the sources of that return are changing in line with the market's dynamics. In 2018, these dynamics potentially will balance differently compared to previous years. In past years, the asset class has seen positive inflows, at least partially because of the positive yield premium offered by the asset class over its peers. But in 2018, the central driver of returns might reverse towards the shorter-duration characteristics of the class, as investors seek safe havens from rising rates. At time of writing, external risk appetite remains positively disposed towards EM risk. The performance tailwind presented by inflows should continue into the new year. We continue to look for positive returns from local currency, where we think the combination of a high grade, liquid, shorter duration asset class, that offers high yield, should remain compelling. In the hard currency space, we are looking for returns both within the corporate and sovereign space. In our view, a combination of more secure sovereign coupon may work well when blended with a broader approach to credit.

Q 5/ And what could be the strategy to mitigate risk?

We are conscious of risks and their possible impact on performance, both positive and negative. In 2018, a short duration positioning should be central to a risk management approach, which potentially mitigates the effects of rising rates while also potentially suppressing some of the impact of volatility. An active research-driven approach can also be helpful to mitigate risk, by better understanding the dynamics of issuers and potentially identifying negative outcomes.

Equity Portfolios

Top Down Views from Amundi Research

DEBORA DELBÒ, Equity Strategy
ERIC MIJOT, Equity Strategy
IBRA WANE, Equity Strategy

The markets do not price in the end of a cycle until a few months beforehand. As a US recession – and, hence, a global recession – is unlikely in 2018, the markets will probably continue to perform well. However risks are also increasing.

Have US equities become so expensive that they have hit a ceiling? No, but it shows that the risk-reward has deteriorated

Relative to interest rates, US equity valuations are not extreme. However, the lack of supply of bonds has pushed yields to abnormally low levels. So it is worth comparing equity valuations directly with inflation. This is where the "rule of 20" comes in. Each time that the P/E on trailing 12-month earnings moves above the "20-inflation" level, it is overvalued. That is now the case, as it was in 1987 and 1996. In our view, this measure is a good indicator of market exuberance, keeping in mind that while there was a crash in 1987, in 1996 the market continued to rally for another three years.

Is volatility gone forever? No, it should rebound sometime in 2018

Volatility is a trailing function of monetary policy. It generally rises about two years after key rates begin moving up and the Fed began to raise its key rates in December 2015. This is due to liquidity. Adding liquidity reduces volatility, and vice versa. Although central banks are proceeding cautiously, the liquidity argument, which has carried the markets since 2009, is now reversing its momentum. This trend will gather strength in 2018.

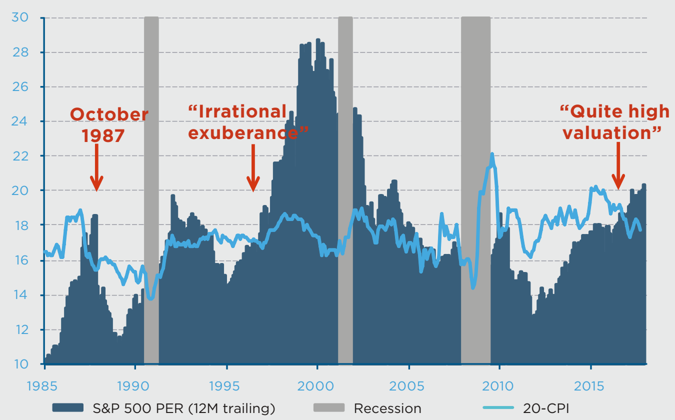
Can earnings continue to drive the markets higher? We think so

The synchronisation of global growth is a favourable factor. In the United States, assuming, conservatively, that margins remain stable, earnings growth will be close to nominal GDP growth, i.e., ca. +4%. In addition, we can look forward to the tax cut, the accretive impact of share buybacks, and the delayed impact of the weak dollar. Thus, the Ibes consensus of 11% EPS growth seems credible.
Elsewhere, margins are likely to improve. In the eurozone, they lag behind the US by 22 months this time. Higher bond yields, which help banks, are a key factor to this improvement. Nor are margins in Japan, which are at a high since the 1980s, showing any sign of weakness. And, lastly, the upturn in earnings in emerging markets is likely to extend into 2018.

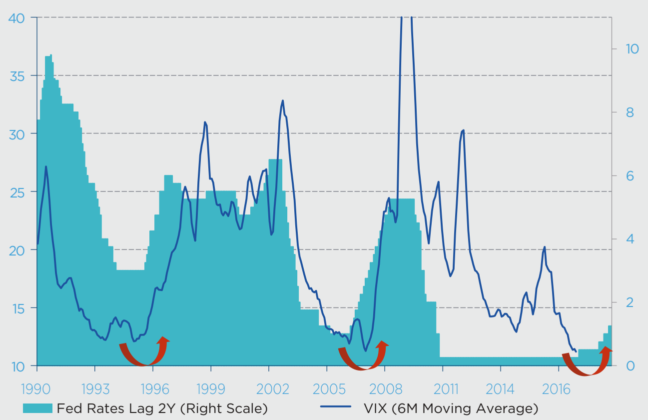
Against this backdrop, what is to be done on a regional level?

While the US market is expensive and the cycle is expected to last beyond 2018, the other markets are less expensive and now re-synchronised with the US and, as a result are more attractive. However, given these markets' high sensitivity to the behaviour of the US market and how mature the cycle is, investors should consider only moderate risk exposure or to implement hedges.

1/ **S&P500 Price Earnings Ratio (PER) and the "Rule of 20"**



2/ **Fed rates and US Equity Volatility**



Source: Datastream, Amundi Research

- **The eurozone**: improved margins, re-steepening in the yield curve (good news for banks), renewed inflows (which, however, would mean an appreciation in the euro) are keys. Political risk (Catalonia) is less systemic in nature. Brexit, of course, is the elephant in the room but is expected to burden UK assets more than European ones.
- **Japan**: further rise in margins, ongoing improvement of governance, and inflows (BoJ and pension plans) are constructive arguments. However, the yen, which is closely correlated to equities, will remain decisive. Shinzo Abe's election success points to continuity in economic and monetary policy (weak yen). However a significant market shock, if one was to occur, would strengthen the Japanese currency and weight on equities.
- **Emerging markets** are riding the synchronisation of global growth, which is also a boost for commodities. This moderately bullish scenario can be derailed by USD appreciation, Fed rate hike (if stronger than expected), Fed balance sheet normalisation, global (and China) growth deceleration.

What are the themes for 2018?

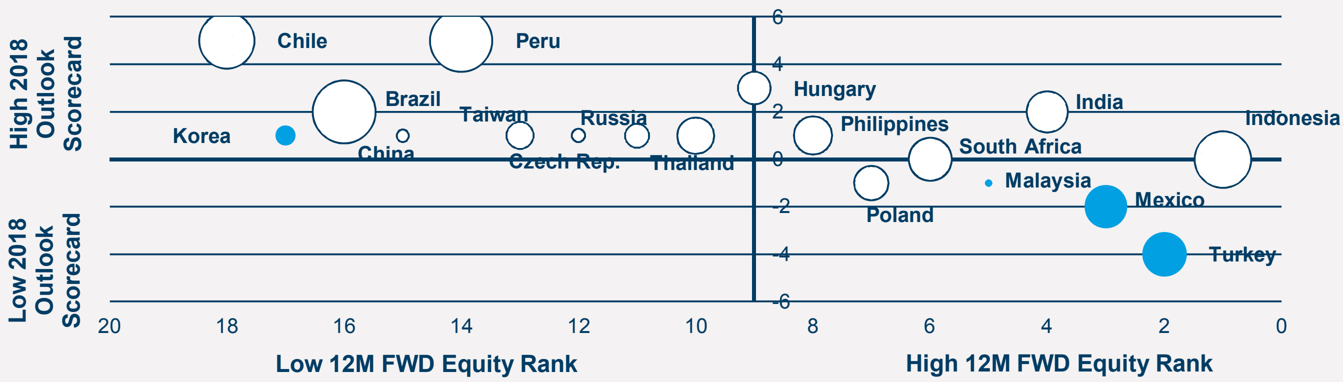
There are four key themes at this stage of the economic recovery:

- **Upturn in inflation:** overweight companies with pricing power (e.g., luxury goods companies). Financials may also benefit from the higher bond yields that are coming late in this cycle.
- **Upturn in investment?** The resynchronisation of global growth and the upturn in earnings are arguments for this theme. However the decline in potential growth is cooling things off. The idea is that investors at least should keep some cyclical exposure and not switch too early to a purely defensive strategy.
- **Look for quality:** Growth stocks are very expensive globally, a consideration that is feeding the theory of a bubble. Quality companies, which are less leveraged and less expensive, are clearly a good trade-off.
- **Watch out for liquidity:** as regards equities, this theme concerns mainly small caps. True, their earnings remain strong for the time being in Europe and Japan. And in the US, the upcoming tax reform is a true argument for these more domestically oriented stocks. However these arguments will vanish during the year as liquidity will be less supportive.

What about Emerging markets?

- **The most appealing area for 2018 is EM Asia**, mainly India, Indonesia and the Philippines. We see three reasons for this: 1) widespread quality, 2) convergence of positive macroeconomic environment (in terms of growth, inflation and liquidity), 3) low vulnerability vs other GEM and good fundamentals. After a strong rally in 2017, China looks expensive. Anyway the ongoing process of reforms can improve the market picture. FXs seem overvalued in many of the Asian countries which warrants hedging positions.
- **We also remain positive on EMEA** (mainly Turkey and South Africa). Equity fundamentals are good and growth will remain supportive. South Africa is appealing (strong earnings and decent valuation). Growth is still weak but improving, with some weakness on the fiscal side. Turkey is inexpensive with high profitability and robust earnings growth. However, a cyclical slowdown in 2018 will call for more fiscal expansion and monetary accommodation, making more difficult for inflation to move towards the CB target. FX seems attractive on a 12-month horizon.
- **In LATAM we are more cautious:** macroeconomic conditions improved during this year but the equity market rally made the area expensive, with the only exception of Mexico. The area could become attractive if some correction occurs.

3/ EM Scorecard



The chart shows the cross between internal 12m FWD Equity Rank and internal 2018 Outlook Scorecard. Countries in the top right section are the most attractive. The economic variable "Reforms underway in China" is not included in this analysis. Bubbles represent the attractiveness of FX: white bubble = downside at 12m horizon; blue bubble = upside at 12m horizon.
Source: Amundi Research, 2018 Outlook Scorecard based on a number of macro indicators (GDP growth, external demand, public sector, inflation, liquidity). 12m FWD Equity Rank based on 12m horizon expected upside (based on macro fair value), medium-term valuations, EPS growth expectation, profitability, positioning and FX medium-term attractiveness.

CIOs' investment strategies: Q&A

Global equities investment strategies

ROMAIN BOSCHER, Co-Head of Equities

Q1 / How do you believe investors should play the 2018 investment environment in terms of positioning and budgeting for risk?

Overall valuation levels and the length of this bull market dictate that risks regarding equities will likely be higher in 2018 than in previous years. However, earnings growth continues to accelerate, Central Bank tightening is modest, and there are compelling funds flow arguments for equities. Earnings are consequently in the driver's seat and flows could inflate valuations further. On the negative side, Central Banks' behaviour could be a trigger for a more adverse scenario if interest rates move significantly higher. In other words, the outlook that could emerge is a kind of 'Goldilocks' case or a move away from it, depending on the speed/ intensity of monetary policy normalisation.

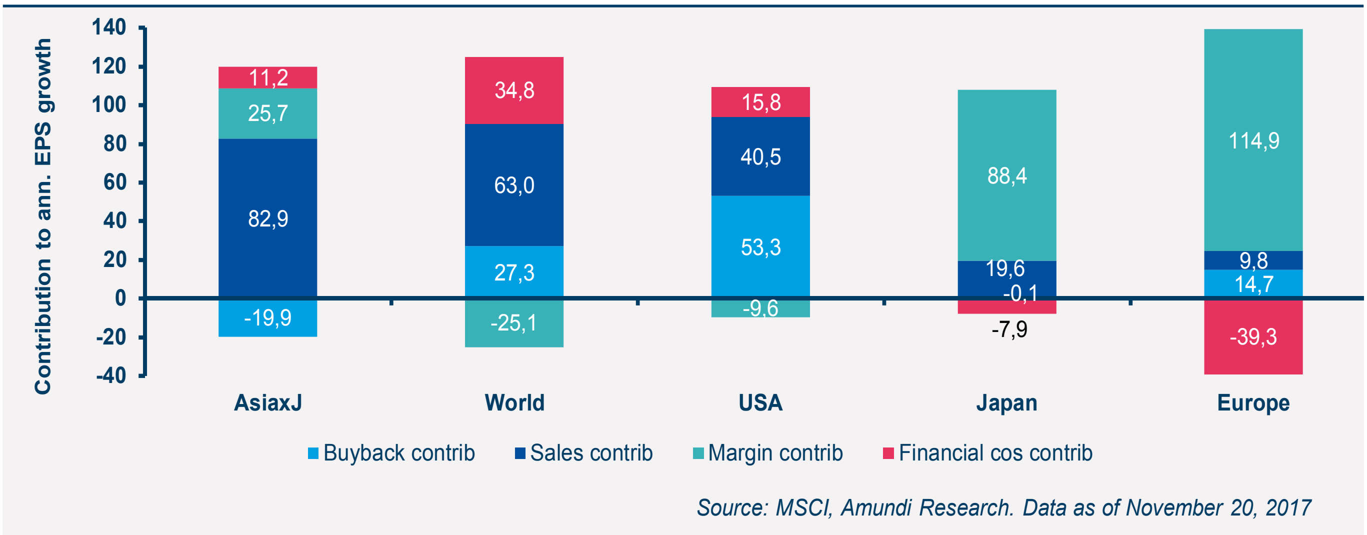
Regarding the importance of earnings at this stage, we are paying attention to earnings growth, but also to sustainability of growth. On the former issue, we prefer Europe and EMs, which combine higher and better earnings per share growth prospects, fuelled more by higher margins than by share buybacks, as highlighted in the chart below. But when it's about quality and sustainability of earnings, Japan is offering a convincing profile. From a sector point of view, we are paying attention to those stocks that have seen extreme benefits from an every-day-lower-rates environment.

These bond proxies could suffer, at least in relative terms, which would explain why, for instance, we believe investors should prefer consumer discretionary to consumer staples stocks. It could also be worth underweighting domestic UK and US industrial stocks.

Q2 / What are the major changes in your investment outlook for 2018 compared to 2017, and how have these come about?

We think that it's too late to be a trend-follower. In other words, we believe investors should avoid momentum, preferring value and quality. Some high-dividend names, after significant though not massive underperformance, could potentially do better in a bumpier market.

1/ **MSCI regions: EPS growth breakdown (last five years**



Source: MSCI, Amundi Research. Data as of November 20, 2017

Q3 / What are the main issues/events to watch during the year, and why?

US inflation rates, central bank policy (in the US, Japan and Europe), and US 10-year bond yields will, in our view, be by far the most important factors to monitor in 2018. An increase in short and long rates plus modest curve steepening could signal normalisation of the cycle 11 years after the Global Financial Crisis and could lead to some important rotation in equity markets.

A more rapid normalisation of inflation, particularly in the US, would raise the possibility of policy mistakes by central banks which would likely end this market cycle. This is not our central expectation, but is a risk to be aware of.

Q4 / In your view, what are the biggest opportunities and risks not priced into the markets for the new year?

We could still benefit from synchronised global growth in 2018, combined with modestly rising inflation. The uplift in nominal growth could have a material impact on earnings in 2018, particularly when combined with modest fiscal expansion. This backdrop would favour financials and economically sensitive stocks as well as smaller capitalisation stocks at the expense of mega cap growth stocks. It would facilitate the closure of the last valuation gaps available in the market.

Q5 / What could be the most appropriate strategy to mitigate risk?

In our view, playing geographic opportunities, with a rigorous and disciplined focus on valuations, avoiding excessive financial leverage and poor governance frameworks, plus the retention of some high-quality names, even after a strong rally, would be the most sensible ways to mitigate risk in the scenario outlined above.

European equities investment strategies

DIEGO FRANZIN, Co-Head of Equities

Q1 / How do you believe investors should play the 2018 investment environment in terms of positioning and risk budgeting?

It is our view that in 2018, we will probably see the late phase of one of the longest cycles of the last 100 years. In general, these phases of consolidation are associated with economic deceleration, as inflationary pressures and rising rates have an impact on wage growth, capital investments and, ultimately, profitability. It is our opinion that this late-cycle phase will be atypical and will be characterised by: (i) a subdued level of inflation, which is on the rise across Europe but is nowhere near a point that would prompt the European Central Bank to take strong action; (ii) a recovery in capex to meet rising customer demand both domestically and outside of Europe; and, more importantly, (iii) a continuation of the earnings recovery which made 2017 such a remarkable year. European earnings should continue to experience support from the operational leverage that has improved in the aftermath of the Global Financial Crisis and the Sovereign crisis, allowing them to be ready to reap the benefits from a recovery in top-line growth.

Lastly, valuations in the European market appear full in absolute terms, but are quite interesting from a relative perspective, which should offer further support for the asset class in the coming months.

Q2 / What are the major changes in your investment outlook for 2018 compared to 2017 and why?

We expect 2018 to be a market environment in which European equities will remain in the spotlight. We believe that earnings growth will be the main fundamental factor driving performance, but we also see external factors (macroeconomic events, political elections, monetary policy changes) that could potentially cause an increase in volatility, and thus possible rotation within the market. Now more than ever, we believe that it is very important to maintain a balanced approach to portfolio construction, avoiding major style biases and focusing as much as possible on idiosyncratic investment cases that have the potential to deliver consistent and reliable earnings growth over the medium-term, independent of the phase of the market. If anything, we believe investors should start thinking about portfolio construction with “a hedge”, which can take a different format depending on the investment strategies. Quality and sustainability of the business model will, in our view, act as a natural hedge for stock picking approaches and should be favoured in this phase of the cycle. For other strategies, some optionality could be appropriate. So, our keywords for 2018 are “balanced with a hedge”, focusing all the attention on individual companies’ investment cases.

Q3 / What are the main issues/events to watch during the year and why?

As we mentioned previously, our view remains that the continued delivery of earnings growth will be the main catalyst for the market to move higher, therefore we will be paying very close attention to the upcoming reporting seasons. From a more macro perspective, we see any action from central banks globally, regarding their intentions to withdraw monetary stimulus, as a potential driver of sentiment. From a political standpoint, any progress from the US administration on tax reform (which could impact the earnings outlook for US corporates) may have an impact, not only on European equity markets but around the globe. In addition, 2017 has proved to be a pivotal year for the European political landscape as concerns about a populist revolt did not come to pass, given the positive outcome of the French presidential election and, more recently, the German elections. That said, in 2018, Italy will go to the polls and this could be a source of short-term volatility, while the ongoing situation in Spain regarding the independence of Catalonia could spark bouts of volatility. Finally, a strengthening euro could also be a headwind for European equities; however, we expect this to weigh more on sentiment than on actual earnings power.

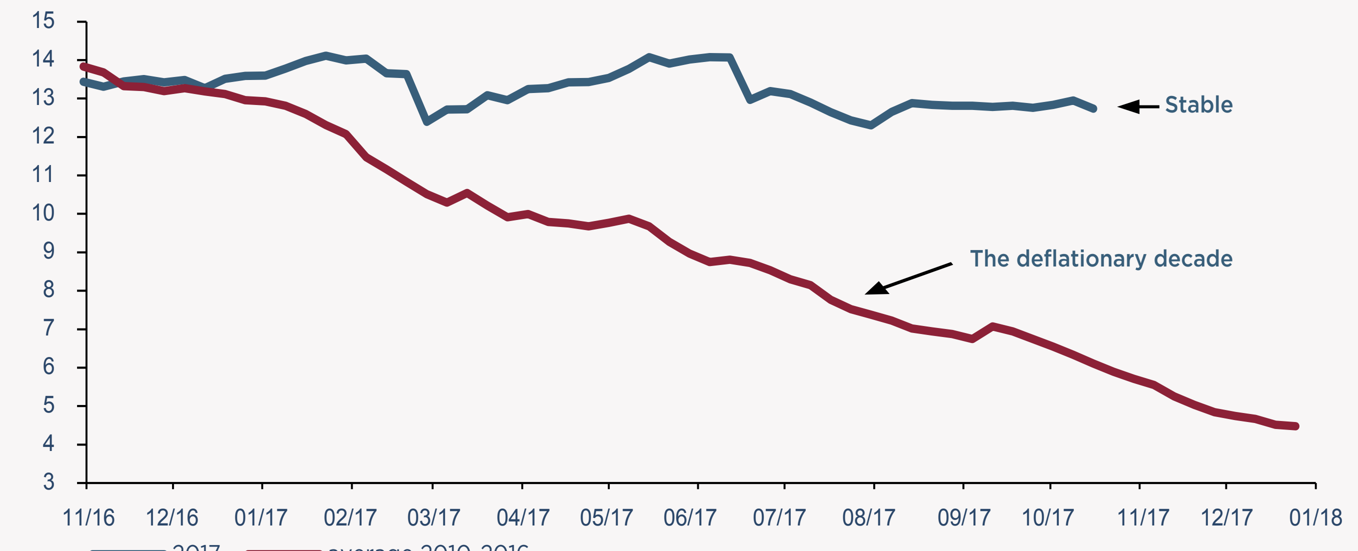
Q4 / In your view, what are the biggest opportunities and risks not priced into the market for the new year?

In our view, unforeseen political and macroeconomic events at a global level are the risks that could derail an otherwise positive market for European equities. The strength and the geographical breadth of the global recovery might indeed offer some additional surprises to equity investors, particularly those disciplined enough to concentrate their allocation in sectors that will benefit from an expansionary market environment. Here, value may offer some attractive opportunities.

Q5 / And what could be the strategy to mitigate risk?

The key risks to bear in mind are connected with a rise in volatility and in a breakdown in correlations – both within sectors and in the market in general. Our central scenario is that of a late-cycle positive performance for the equity markets; however, given the risk of sudden disruptive rotations, we believe investors should focus on idiosyncratic investment cases or consider hedging to mitigate systemic risk.

1/ **Revisions to the Consensus Estimate of Average Current Year EPS Growth (Europe)**



Source: Amundi Research, Datastream, Kepler Cheuvreux

Japanese equities investment strategies

ROMAIN BOSCHER, Co-Head of Equities

Q1 / How do you believe investors should play the 2018 investment environment in terms of positioning and budgeting for risk?

The macroeconomic conditions are not likely to change much next year for Japan. In our view, the Bank of Japan has little room to reverse its accommodative monetary policy. Japanese firms should experience earnings growth, but the consensus outlook points to rates slowing significantly from 16% yoy in FY17 to 7% yoy in FY18 (our estimates are in line with the consensus) after having benefited from the global economic recovery. At the sector level, despite rich valuations, we have a positive outlook on electronics, semiconductors, and industrial machinery on the back of advances in the "Internet of Things" and an imminent necessity for labour substitution. ADAS (Advanced Driver-Assistance Systems) are a growing opportunity for these sectors, along with other drivers, such as smartphones and games. The trend towards electric vehicles will eventually cause a transition of leaders in the market, from automotive to electronics companies. Moreover, many companies have started investing in automation to bolster productivity – e.g., assembly line automation and self-checkout systems at retailers – as a natural development in response to demographic shifts in Japan.

Q2 / What are the major changes in your investment outlook for 2018 compared to 2017, and on what factors are these based?

The investment style may gradually shift to value given decelerating earnings growth in 2018. Overseas flows could favour large caps as more global asset allocators rebuild their exposures to Japan after confirming the political stability of the Abe administration.

Q3 / What are the main issues/events to watch during the year and why?

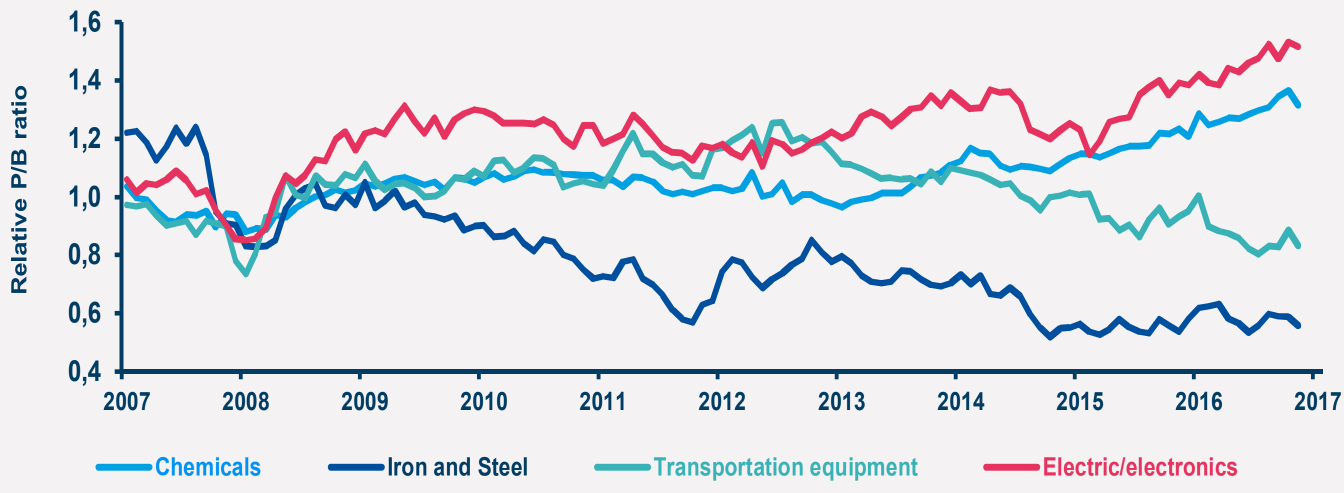
We see four major issues to watch next year that could drive the market:

1. The BoJ could potentially recalibrate its policy trajectory. As the Fed and the ECB begin balance sheet reduction and tapering, respectively, the BoJ could face political pressure if the yen were to depreciate significantly as it maintains its current policies of "QQE + YCC" (quantitative and qualitative easing and yield curve control, respectively). We see three options being available to the BoJ: pegging the yield officially targeted by the BoJ of a shorter maturity; revising up the BoJ target for the JGB 10-year yield; steadily reducing asset purchases. The main implications for the market of a policy recalibration along the lines noted above could provide support to banks.
2. Revision of labour laws to address current labour shortages as part of the "work style" reform. A conversion to permanent employment could drive a reduction of precautionary savings, with potential positive implications for consumption/domestic demand-related stocks.
3. Arguments regarding another consumption tax increase (from 8% to 10%) could be made. Despite PM Abe's statement prior to the snap election, a rate hike could result in a prolonged negative impact on consumption and business activity, likely negatively affecting consumption stocks.
4. Growing awareness of ESG (environmental, social, governance) could have an impact on policy decisions. This is a global trend. The market would begin to price in ESG factors as more managers try to incorporate non-financial information into company processes while addressing a need for better disclosure. This situation has the potential to generate asymmetries in company returns, increasing the scope for selection and active management.

Q4 / In your view, what are the biggest opportunities and risks not priced into the market for the new year?

A positive factor for the market, which is not fully priced in, could be the debate over taxing retained earnings, a point raised during the electoral campaign. This could well push for a demand for capex and earnings distribution to shareholders and/or employees. On the downside, the main risk is a margin squeeze due to surging energy costs on the back of rising geopolitical risks. This scenario could materialise if oil were to move towards USD 70/bbl. In order to mitigate the risk, during the year, it will be important to apply rigorous fundamental analysis to financial and non-financial aspects, and to constantly review the state of invested companies based on economic and earnings contexts, and in relation to how alternative scenarios (positive and negative) could potentially unfold.

1/ Leadership migration: sector Price to Book ratios vs. Topix



Source: Bloomberg, Amundi Research. Data as of November 10, 2017

US equities investment strategies

MARCO PIRONDINI, Head of Equities, US

Q1 / What are the most attractive investment opportunities for 2018?

We believe US large value stocks offer the best risk-reward for three reasons:

- Large value stocks have greater exposure to cyclical growth than growth stocks. We believe the US and global economies are still reflating, which should benefit value stocks over growth stocks
- Tax reform, if passed, will likely cause economic growth to accelerate, benefiting value
- Value has underperformed growth by over 16% in 2017 as investors have favoured high growth stocks such as Netflix and Tesla over value stocks. We think this extreme outperformance of growth over value is unlikely to continue, especially given a positive backdrop for most value sectors and stocks.

Within the value universe, we believe financials will perform particularly well as they should benefit from a higher interest rate environment and low levels of credit defaults. In addition, we believe reasonably valued technology stocks are attractive given their exposure to both a strengthening economy and underlying secular growth trends, such as the shift to mobile computing. Conversely, we are less optimistic about interest rate sensitive sectors such as consumer staples, REITs, and utilities.

While the enactment of tax reform is far from certain, it would likely provide an additional boost to GDP growth. Lower taxes at both the corporate and individual level will almost certainly result in higher investment and consumer spending, which should benefit stocks that are tied to the economic cycle.

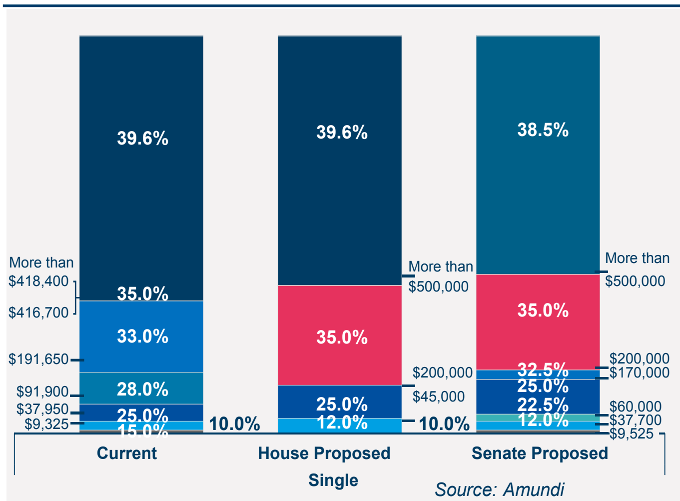
Though the environment is positive for investing in US equities in 2018, there are risks to this outlook including the potential for the Fed to become more aggressive in raising interest rates if inflation picks up, uncertainty with respect to public policy, and geopolitics.

For this reason, we believe it is a particularly good time to invest in equities with an active management approach which seeks to balance risk and return.

Q2 / What are the major changes in your investment outlook for 2018 compared to 2017 and why?

The major difference in investment approach entering 2018 versus 2017 is the focus on owning stocks that should benefit from a reflation of the US economy. While economic growth in 2017 has been solid, it has not been as high as some thought it would have been after the presidential election in 2016. However, the economy has strengthened as the year has progressed: consumer confidence is high, business investment is rising, and productivity has increased. As a result, we believe GDP growth has the potential to surprise to the upside in 2018 even without tax reform and could be the highest level in years if tax reform passes.

1/ Current vs proposed US income tax structure



Source: Amundi

2/ Possible surprises to watch for in 2018

Positive Surprise	Negative Surprise
• Tax reform on US economy	• No tax reform
• Rebound of US consumer	• Inflation spike
• Rebound in depressed consumer discretionary stocks	• Central Banks ineffective
	• Global / political events

Q3 / What are the main risks to the equity market in 2018 and why?

The main risk to the equity markets is the inability of the US Congress to pass tax reform. If unsuccessful, our outlook for equities in 2018 would change. In addition, we are concerned that interest rates may rise more than excepted due to higher than anticipated inflation. With unemployment at 4.1% in October, the US economy appears to be at or close to full employment, so further growth may cause inflation to accelerate. This could cause the equity markets to decline in anticipation of a potential decline in economic growth in 2019. Other risks include geopolitics and political gridlock in Washington, DC.

Q4 / And what could be the strategy to mitigate risk?

There are two ways to mitigate risk. The first is by focusing on quality. Investors should focus on companies that have high returns on capital, sustainable competitive advantages, and low debt levels compared with peers. The other, is through portfolio construction, sizing positions at the security, industry, and sector level to maximise return while limiting risk. As the main risk we see is in acceleration in interest rate, a way to mitigate risk is by keeping a very cautious view on interest rate sensitive sectors.

Emerging markets equities investment strategies

MAURO RATTO, Head of Emerging Markets

Q1 / How do you think investors should approach the 2018 investment environment in terms of positioning and risk budgeting?

Although we expect a slowdown in the current strong macroeconomic momentum, we maintain a generally positive outlook for EM. Fiscal and financial conditions, with few exceptions, are quite stable across all regions on the back of the reforms implemented over the last three to four years, facilitated in some cases by the overall improvement in the global environment. The Brazilian recovery story is a case in point, still offering attractive opportunities in its cyclically exposed sectors (i.e., energy, consumer and industrial).

On a selective basis, Russia is also an interesting opportunity; we welcomed the improvement in governance practices that recently resulted in the country's biggest bank raising its dividend payout ratios. This might benefit the whole market in terms of equity risk premium. Potential surprises could come from South Africa, specifically regarding the potential for new leadership replacing President Zuma; this could lead to a reform-driven recovery similar to that seen in Brazil. The same analysis could also apply to Mexico, where the political situation is very fluid.

China appears comfortable with its new GDP growth model, based on a mix of increasing domestic growth led by consumption and the new economy sector becoming a material contributor to overall growth. An improved state-owned enterprise (SOE) model has tentatively been achieved by managing the supply/demand imbalances in key areas such as the commodity sector. This new model seems to be able to coexist with a positive producer price index (PPI) figure for 2018, a key enabler for the transition. Indeed, a positive PPI is critical for both the profitability of Chinese corporations and to avoid exporting further deflationary pressures. Tightening measures to prevent a bubble in the property sector are very likely and must be carefully watched, as this sector is pivotal for the economy and for sentiment. Nevertheless, the existing stock of unsold properties is declining to reasonable levels: the diminished inventories in tier 2 and tier 3 cities will mitigate the effects of the expected tightening measures. Property valuation metrics are indeed stretched, and investor euphoria is of equal concern.

For the very first time since 2010, EMs are experiencing earnings upgrades across the board, with EPS growing by mid-double digits vs. 10% expected at the beginning of the year. This performance has been driven by a recovery in the material/energy sectors (i.e., improvement in commodity prices led by supply/demand); the increasing relevance of IT consumer-facing stocks, which are still experiencing fast growth (i.e., 40-50%); and a reacceleration in the industrial sector, led by the synchronised global recovery. This scenario is expected to continue in 2018, as no major changes are forecast in the macro outlook and we do not foresee any political shifts.

As far as valuations, EMs still look attractive especially vs. DMs on the back of above-average valuations at about 12-14x earnings, with value/traditional economy sectors offering the best upside (i.e. financials, industrials) in countries such as China, Brazil and Nigeria. Stripping out IT/consumer stocks, valuations are even more compelling at or below 10x EPS, with high-single-digit or low-double-digit growth expected in 2018. Flows have clearly improved since mid-last year, but continue to be dominated by ETFs. The ETF dominance partly explains the outperformance of the growth style and, to an extent, the limiting of the scope for a rerating of value-driven strategies (market cap bias is a big factor in explaining returns in 2017).

We see opportunities in Nigeria, as the economy has started to grow again, driven by oil production/price improvement, reforms and FX regime improvement, making the country investable again. We favour tier 1 banks, which are very cheap compared to their sector (0.6 P/B for a 15-20% return on equity). We like materials (i.e. cement/steel) in China on supply reform-induced benefits and robust demand driven by infrastructure projects and a solid real estate sector.

Q2 / What are the main issues/events to watch during the year and why?

As far as investing in EMs goes, the external factors that are worth monitoring include potential tax reform in the US and the normalisation of unconventional monetary policies in the US and Europe.

Keeping US tax reform expectations alive is indeed relevant to supporting the global synchronised recovery concept. In a growth environment, monetary policy normalisation will cause an increase in rates and a steepening in yield curves, but we don't foresee a major credit spread widening. Indeed, better growth means better balance sheets, preventing or postponing an increase in default rates. If this prediction turns out to be incorrect, we will likely see a meaningful correction in both equity and fixed income markets.

The bulk of EM equity performance has been explained over the last 20 years by faster GDP growth in EM economies compared to developed economies. We do expect emerging equity markets to benefit more and more from the improvement in micro-economic conditions.

In particular, there has been a visible improvement in the quality of earnings in Asia. It is notable that market performance in Asia has been driven by earnings growth, not by multiple expansion. Earnings growth is backed by strong free cash flow (FCF) generation, and for the first time in a decade, the FCF yield is higher in Asia than in the US. We expect EPS growth and the improvement in its quality (FCFY) to be key return drivers in absolute and relative terms.

The improvement seen in South Korea in terms of governance, if extended to other countries/regions, can become the most significant factor and a cornerstone of the next sustainable EM rally.

Q3 / In your view, what are the biggest opportunities and risks not priced into the market for the new year?

Beyond the geopolitical risks we see, the Fed's policies and their implications for the US dollar are the main risks, in our view. As far as geopolitical risks are concerned, North Korea remains an underestimated risk, we fear, while the situation in the Middle East is definitely a more immediate concern. The most recent events in Lebanon pose a serious threat to the precarious equilibrium in the area. The risk of a war in the region and the economic consequences and reverberations of the oil price on the US dollar could rock the foundations of the prevailing benign scenario. In terms of developments from already planned events, we are closely monitoring the outcome of the upcoming elections in Brazil and Mexico. Our central case scenario still sees a market-friendly candidate as the most likely outcome in both countries. We are also monitoring closely the political situation in South Africa, as developments there are pivotal for the outlook for the country and its corporations.

Q4 / And what could be the strategy to mitigate risk?

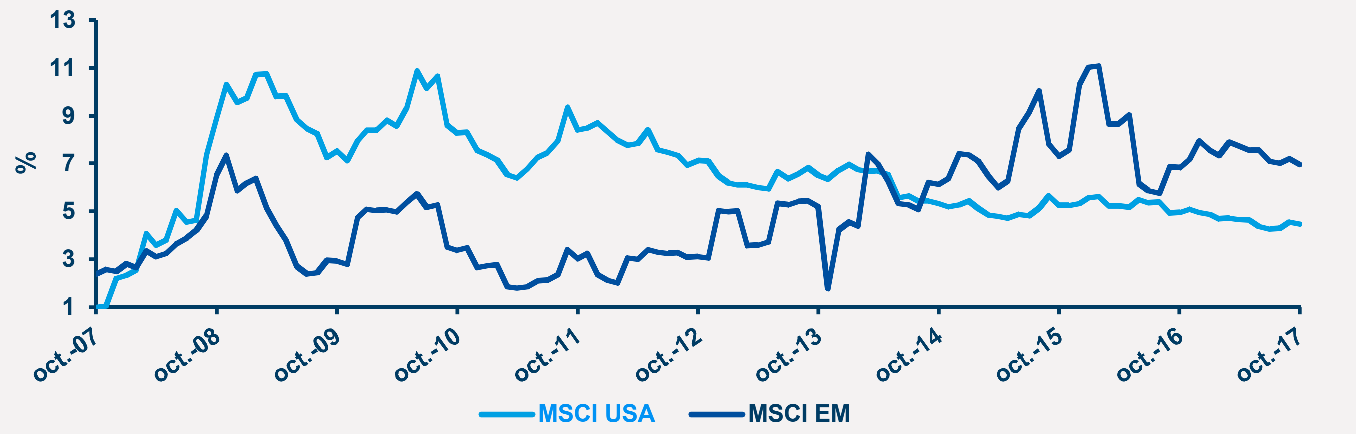
The ideal portfolio that factors in the high conviction ideas and risks highlighted above should be, in our view, a mix of quality and ad hoc stocks in which insofar as possible, any investment case incurs idiosyncratic risk[1]. This portfolio construction effort should reflect a macro framework that considers all the topics discussed so far. In that sense, we believe investors should favour countries with strong fundamentals that are less exposed to a strengthening US dollar or to a spike in oil prices. A stable oil price at, or around, current levels (USD50-60/bbl) is still our central case.

Q5 / What are the major changes in your investment outlook for 2018 compared to 2017 and why?

A late cycle mindset should drive portfolio construction in 2018, in our view. The themes to be played should be less sensitive to operating and financial leverage. Consistent with what we have discussed, the focus should be on some

[1] *Idiosyncratic risk is the risk associated with a particular investment due to the unique characteristics of that investment. Idiosyncratic risk can be managed through diversification in an investment portfolio.*

1/ Free cash flow yield US vs EM



Source: Bloomberg, Amundi Research. Data as of November 14,2017 of the themes that add quality, with good growth potential. The "G" component of an ESG approach (Environmental, Social and Governance) could add meaningful value, especially at this juncture in the cycle. In other words, we believe investors should rely less on pure "growth" stories than in the recent past, and focus more on quality and hidden opportunities. In addition, there is still space for "restructuring" stories that can offer interesting value. Overall, we believe that in the market environment we envisage for 2018 (less directional, and where relative value opportunities should be exploited to add value), it will be particularly important to take an integrated investment approach which combines macro- and micro-economic bottom-up views. Understanding this should help investors to navigate the macro themes (global, regional, and country specific) and sector-/stock-specific drivers in order to capture upside potential in the market and limit downside risk.

Factor Investing Portfolios

Top Down Views from Amundi Research

ERIC MIJOT, Equity Strategy

The Quality factor: the right trade-off for 2018

To our minds, it is too early to take on a purely defensive profile, and it is too late to follow growth stocks, which are already very expensive. If we had to choose a single factor on which to focus, Quality would surely be the best trade-off, in our view. Below, we present our reasoning in two steps.

What is the best factor at this stage of the cycle?

Since the January 2016 oil price bottom-out and China's efforts to prevent capital flight, the equity markets have rallied and resynchronised, as have economies, in a phase ii of the cycle.[1 2] At the factor level, this phase is usually at first favourable to Momentum, and then to Quality before being joined by the High Dividend and Minimum Volatility factors, which are more defensive.

Let's now take a snapshot of the current reality

The vertical axis of our map depicts market momentum; if the factor is positioned high, it outperforms the MSCI World (in US dollars) and vice versa if it is positioned low. The horizontal axis depicts earnings momentum. And the size of the circle refers to its relative valuation (the bigger it is, the most expensive it is). As the markets anticipate earnings, the natural direction is clockwise. A colour code highlights three types of factors: Value-Growth, Large-Mid-Small, and then the other styles.

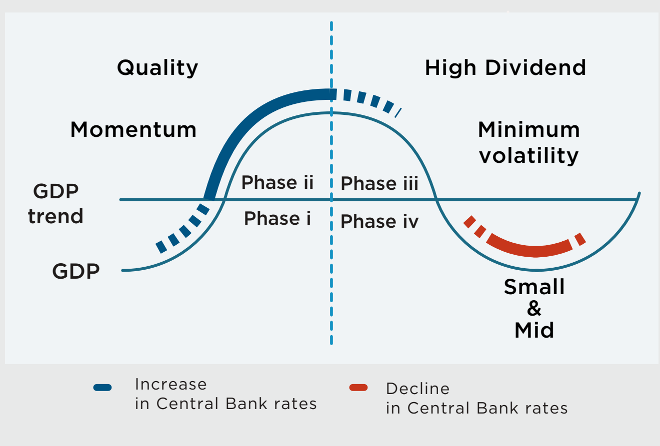
Conclusion

The Growth style outperforms and is expensive, which feeds the bubble scenario. The 'swinging doors' risk is significant. Small caps, more cyclical and domestic, are still rather well positioned in Europe and Japan. Renewed hope regarding tax reform is again boosting them in the US, but low high-yield spreads and volatility, higher margins, a peak of M&A in the US, and the coming reduction of liquidity are likely to ultimately work against them in 2018. As it is less expensive than the Growth style and less indebted, Quality is the ideal candidate to take over from Momentum, which is still outperforming for good reasons, given that earnings are still faring well. And, additionally, the High Dividend and Minimum Volatility factors are lagging behind in both profitability and market behaviour, something that corroborates our interpretation that the global market is not yet positioned in phase iii.

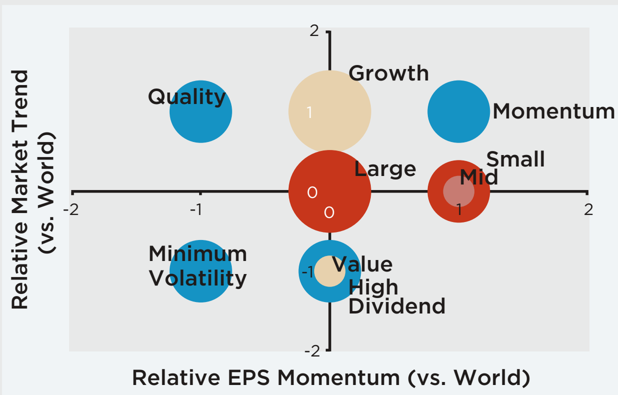
[1] *See the Discussion Paper entitled "Short investment cycles: our roadmap".*

[2] *Europe and Japan are in Phase ii. The United States has, in fact, been in phase iii since the end of tapering in mid-2014, but the resynchronisation of the cycle has generated a sort of phase ii within phase iii.*

1/ **Factors: Our road map**



2/ **Mapping of Factors (MSCI World)**



Source: Amundi Research

CIOs' Investment Strategies: Q&A

LAURENT TROTTIER, Global Head of ETF, Indexing, Smart Beta Management

Q1 / How could investors play the 2018 investment outlook through risk factors?

Factor strategies may enable investors to implement their market views in both a very transparent and cost-effective manner. There is indeed a strong relationship between factor performance and market/macro conditions. An investor with a central scenario focused on GDP growth and accommodating monetary policy could, for example, implement a Value and Momentum programme. However, investors should focus on diversification between rewarded risk factors, so they would complete their allocation with factors such as Low Vol and Quality in order to reduce drawdown potential. Low Vol and Quality would also have the benefits of providing a hedge against a possible return of market volatility. For 2018, it will be important to closely monitor the valuation level of the different factors, in order to avoid any potential overheating. Typically we can notice that the Momentum factor has been favoured by investors in 2017 both in Europe and US for its pro-cyclical stance. However an extended outperformance of the Momentum factor can lead to prices exuberance and tensed valuations. Any materialisation of risk could trigger a quick factor rotation that would negatively affect the performance of Momentum portfolios.

Q2 / What are the main areas of attention?

With a central scenario of GDP growth and accommodative monetary policy, keeping an exposure to equities makes sense. However, equity markets have been gaining quite steadily over recent years, with very low levels of volatility. As such, it is crucial for investors to consider asymmetrical strategies that would outperform if and when volatility returns.

Another source of attention is the growing materialisation of ESG risks and their faster impact on companies' share prices. The best example is the impact of the emissions scandal on the car manufacturing sector. Moreover, we note an increasing amount of regulation and market initiative to tackle climate/environmental issues.

We are seeing investors' demand for ESG criteria to be considered being increasingly accommodated, in their passive and factor portfolios – which is a good illustration of how key these risks are becoming for asset owners. Such a trend may contribute to improving company behaviour and as we see it probably fuel a virtuous circle.

Correlations of excess return – Global 2002-2017

	Quality	Value	Size	Minimum Volatility	Momentum
Quality	100%				
Value	-54%	100%			
Size	-31%	29%	100%		
Minimum Volatility	39%	-30%	-18%	100%	
Momentum	32%	-22%	17%	35%	100%

1/ Mapping of our selected risk factors

Source: Amundi Research

Real Assets Portfolios

Top Down Views from Amundi Research

PHILIPPE ITHURBIDE, Global Head of Research

The macroeconomic and financial environment as described by our research and portfolio management teams remains favorable to real assets:

- **Strong and resilient growth**: growth around its potential in the United States, relative stabilisation in China, renewed strength in the eurozone (with a fall in the unemployment rate and a recovery in investment), improvement in global trade, emerging world still in progress with, in addition, Russia and Brazil emerging of recession...;
- **Monetary policies still accommodating**, but which have begun to undergo changes, led by the United States and the euro zone (in other words, changes that should impact traditional assets);
- **Resurgences of inflation fears**, albeit moderate, but which will undoubtedly restore interest in inflation-hedge asset classes, as can be found in the world of real assets;
- **Moderate bond yields increases**.

Beware however: under the term «real assets», one finds very different assets (sub-asset classes). When we refer to real and alternative assets, we often talk about real estate (which alone includes many sub-classes of assets), private equity, private debt, hedge funds, but also commodities, natural resources, hedge funds or even inflation-linked bonds. In other words, it is not a homogeneous block, which makes it all its richness. In a nutshell:

- There are many classes and sub-classes of assets whose positioning differs over a different business cycle or an inflation cycle;
- The weak correlations between these subclasses underlines the need of considering them separately (in complementarity), and not as a block (in substitutability);
- These weak correlations also encourage consideration of asset subclasses at different stages of the cycle, and not in a uniform way.

The table below gives an account of this reality (it presents, as an indication, the positioning of the different asset classes in "traditional" cycles):

	Accelerating growth and accelerating inflation	Decelerating growth and accelerating inflation	Contraction of growth and decelerating inflation	Accelerating growth and decelerating inflation
"Traditional" asset classes	• Equities • Corporate bonds	• Gold • Equities	• Sovereign bonds	• Corporate bonds • EMG equities • Sovereign bonds
Real assets	• Commodities • Real estate • Private debt • Development capital • Buyout	• Inflation-linked bonds • Real estate	• Restructuring assets • Distressed debt	• Development capital • Buyout • Restructuring assets • Distressed debt • Real estate • Private debt

Other essential characteristics must be emphasised:

- These assets help to circumvent the low interest rate environment;
- They protect against inflation, particularly thanks to the recurrence of their cash flows and their indexation method;
- They also allow to benefit from interesting correlations...;
- The integration of real assets (real estate, private equity and private debt) in a diversified portfolio finally makes it possible to better live the crisis periods. According to our work, the benefits in terms of diversification and the capacity to capture liquidity premiums indeed improve the risk indicators of the portfolios (maximum drawdown, recovery time of drawdowns...).

Lastly, institutional investors are still under-invested. They are indeed well below their targets, and this is true for all asset classes, and especially for infrastructure. This under-investment can be explained in several ways:

- Abundance of capital,
- A lower rate of capital deployment than before,
- The relative scarcity (offer vs. demand) of the deals,
- High valuations in some major countries,
- Countries near the end of the cycle,
- The prospect (fear) of rising US rates,
- Greater geopolitical risks.

But as regard investors, the trends remain intact. According to the most recent surveys (Preqin 2017), four real asset classes should be the subject of more ambitious investments in the coming years: private equity (48% of investors plan to allocate a larger portion of their portfolio in this asset class versus 6% who plan to reduce it), real estate (36% vs. 10%), infrastructure (53% vs. 11%), and finally - and especially - private debt (62% vs. 8%). The hedge fund asset class is the only one that seems to have been abandoned for the coming years (31% of investors expect divestments, while 15% plan to invest more).

CIOs' Investment Strategies

PEDRO ANTONIO ARIAS, Global Head of Real & Alternative Assets

We believe that market conditions and structural factors will continue to support the demand for real assets in both emerging and developed countries. There is a clear shift to private illiquid assets with fund-raising recovering its pre-crisis level amid $600bn of inflows in 2016 to private equity, real estate, private debt and infrastructure. The AuM of those asset classes reached a record high of $7.7tn in 2016, and PwC estimates that so-called 'alternative' assets will reach $13.6-15.3tn in 2020[1]. In a low yield environment, with structurally high demand for income, we believe investors are likely to continue to seek to diversify their portfolio exposure to potentially capture illiquidity premium to enhance returns. Beyond markets, prudential regulation (Solvency II for insurers, Basel III for banks) and demographic shifts (such as life expectancy and urbanisation) are driving the demand for alternative sources of financing to complement banks' intermediation in financing the real economy.

With an outlook of interest rates trending higher in the medium term, as a reflection of stronger growth and inflation, real assets can be seen, with a long-term perspective, as a hedge against inflation. With this purpose, real estate and infrastructure are the most appealing strategies. Real assets can also be considered as an interesting potential substitute to fixed income, albeit keeping the higher liquidity risk in mind. In fact, some real assets have a pattern of very predictable cash flows, on the back of a stringent contractual framework (private debt, core/core+ real estate, infrastructure).

PRIVATE DEBT

Private debt is a segment of the traditional fixed income universe, and is used within the credit continuum to cover assets resulting from banking market disintermediation. This market has seen strong growth over the past five years. We estimate that corporate financing in Europe exceeded €100bn last year. Since the 2008 crisis, the credit supply from banks has been extremely constrained by national and international regulations, such as Basel III. In such an environment of long and extremely low rates, many investors are looking for returns and diversification that the private debt asset class delivers.

Private debt has similar drivers to fixed income with stable and predictable cash flows and principal preservation. However, it captures other return premiums (sourcing, complexity, size, etc.) and increases diversification, thus reducing concentration risks to credit portfolios with access to both corporate assets and real assets (real estate, infrastructure, aircraft, etc.), not available on traditional debt capital markets.

REAL ESTATE

Real estate performance is affected by two main factors: property valuations and rent variations. The European economic recovery could favour real estate as demand for space is expected to increase from tenants, pushing rents upwards as it is expected to do in France. Rent trends could become the new driver of real estate performance, while the past five years have seen real estate prices driven essentially by yield compressions. However, prices could be affected by a potential interest rate increase in Europe, for certain assets, despite the expected preservation of attractive real estate risk premium. Investors should consider that real estate covers a wide range of strategies (core, core+, value-added to opportunistic) with a highly varied range of assets (offices, retail, logistics, residential). Each of these specific factors has an impact on both the investment profile and exit strategy, and therefore its liquidity. In our view, active real estate management strategies (e.g., leasing-up, renovating or total refurbishing) are more crucial than ever in order to deal with current high valuations and the future risk of higher interest rates.

PRIVATE EQUITY

Private equity is one of the best performing asset classes in asset management history, with an attractive illiquidity premium (up to 400bps versus local comparable listed equity markets). On the back of this strong historical performance, it has become the second-largest alternative asset class with $2.5tn assets under management. This popularity has created an unprecedented amount of money committed by investors, but not invested: dry powder in private equity has reached a record high of above $800bn. We therefore question whether the strong performance of the asset class can be maintained at a time of highly priced transactions, and whether private equity managers can find attractive new investment opportunities. High valuations may be beneficial to fund managers that are able to exit their investments at the current prices. Overall, investors should keep in mind that value creation in this asset class needs time, and private equity should not be used under a 10-year investment horizon. As a reward for this high level of illiquidity – and no cash-back before seven years on average – we believe that private equity remains the best investment solution to maximise returns.

INFRASTRUCTURE

As the need for a transition from cyclical to a more structural recovery will be at the forefront for policy makers in the years to come, we believe that infrastructure investing may provide an interesting opportunity to both diversify risks and enhance returns. Investor satisfaction with the asset class has reached a three-year high with 89% of investors now having a positive view. As the demand for infrastructure investing is very high, the case for selection is even more important to find investment cases at reasonable price. The asset class is very heterogeneous, some infrastructure solutions are risky by nature because they are linked to economic cycles or commodities price (e.g., airports, oil sector, merchant exposure), while some others provide excellent predictable cash flows – owing to a very strong and long-term contractual framework (e.g., French energy transition). However, investing in this asset class is complex – especially when considering liquidity and exit possibilities: some infrastructure assets can be sold in a couple of months, while some others benefit from special tax or regulatory conditions and have to be held for 20 years.

[1] *PwC Market Research Centre analysis based on Preqin, HFR and Lipper data. PwC report published in June 2015: "Alternative Asset Management 2020 – Fast forward to centre stage". All other data in this page are from Prequin.*

Forecasts and Expected Returns

Long-term trends: growth vs stagnation, megatrends, geopolitics and public debts... the main structural themes

PHILIPPE ITHURBIDE, Global Head of Research

In the foregoing pages we have developed our scenarios for 2018 and beyond, as well as the investment themes, the risk factors, and the strategies implemented in the different portfolios. All this is based on convictions, forecasts, valuations of assets, potential impacts of various risk factors and therefore risk allocations. But beyond the forecasts and scenarios for the next two or three years, there are other crucial questions, in the longer term this time. The answer to these questions determines the 10-year views in the forecast and expected returns tables.

Q1 / Have we really entered an age of secular stagnation (or even secular deflation)?

This is a crucial question because if this is the case, not only would the current improvement in overall growth be small, but it would also be unsustainable. The factors that lead to secular stagnation are now well known: (i) demographics and aging of the population, (ii) the decline in productivity gains, (iii) the rising and cleaving cost of education, (iv) the burden of the debt (public and private) and deleveraging that constrain pro-cyclical policies (fiscal and tax policies in particular); v) monetary policies (whose efficiency is reduced and room for manoeuvre is now non-existent), vi) globalisation (which pushes down real wages in particular). A simple way to calculate potential growth is to take into account the evolution of the labour force (the population of working age) and productivity gains. It is easy to see the generalised decline in potential growth, which is more pronounced in some countries because of demography (China, for example, growing old before being rich), and in others because of declining productivity gains (United States).

It is a simple method, but the results are at present uncertain, especially because of the productivity component. Several "schools" clash: some authors consider that it is not possible to measure this indicator correctly; others believe that gaps between companies, sectors, regions and countries are confusing the overall message; others argue that the implementation of new technologies takes time, and that the impact will be visible in only a few years; others argue that the first phase of innovation translates into "creative destruction" in the long term, while others believe that the effects of the Third Industrial Revolution linked to NICTs (New Information Technologies and Communication), which began in the 1960s, would be (already) completed. Overall, potential growth calculations are unreliable because they are too dependent on a debatable component. Reasoning in terms of potential growth seems risky.

We must qualify all that. Not only do the factors of stagnation / deflation not all have the same scope, but they do not apply to all countries either. Some are very present, others less crucial now. Others can be corrected by economic policy actions. **Overall, it seems reasonable to bet on improving productivity conditions, but given the weight of some of the structural factors discussed above, long-term growth is not expected to increase significantly, though**.

Q2 / What are the many factors that underlie secular stagnation, those that are sustainable, and those that are not?

Answering this question makes it possible to better specify the countries or areas in danger of secular stagnation, and those that may eventually be able to overcome them for a long time. The table below shows the state of the debate and our convictions.

In total, **fears of secular stagnation are more legitimate in advanced countries than in emerging countries (excluding China) and developing countries**[1]. But some structural factors are not inevitable: corrective measures are still possible.

Q3 / How can an investor manage the low interest rate environment and fears of secular stagnation? What do megatrends bring to long-term investors?

Megatrends are structural changes that impact society, the economy, politics, our everyday lives. They represent breaks, "disruptions", and therefore investment opportunities. They have three major characteristics: (i) large-scale effects, (ii) long-lasting effects, and (iii) global effects. Megatrends can be grouped under four headings: i) demographics, ii) technology, iii) the environment, and iv) social, behavioural, ethical values.

[1] *The most pessimistic nevertheless go even further, and refer to secular deflation. Technical progress (new technologies, IT, robotics...) would therefore be globally deflationary because they allow to produce much more and much better with fewer employees (theme of "growth without employment"). Fiscal, tax and income policies, when rigour turns into austerity would also be deflationary because they would have the almost unique objective of allowing the payment of interest on the debt.*

Investing in megatrends presents several advantages in the current environment: it is a good way to invest in future "winners", to get out of benchmarks (representing past winners), to get out of the themes of secular stagnation (low growth, low interest rate environment) and to better expose to secular growth, reducing exposure to purely cyclical factors and benefiting from thematic approaches. It is also a good way to find a better risk / reward ratio, and invest where the risk is still paid.

	Effective factor of stagnation	A persistent factor? Our conviction
Productivity gains		
Technological progress	An undecided debate on (too low) productivity gains	Probably not persistent
Disruptions	Creative destruction vs. destructive creation	Disruption, a persistent phenomenon… with secular growth opportunities
Demography		
Ageing population	Yes, particularly on advanced countries, on China… Africa not really impacted	A persistent factor… immigrate can reduce trends (Germany as a good example)
Infrastructure	This factor could have been more favourable to growth (delay in relation to needs)	Should become a positive factor for growth
Inequalities		
The "Global divide"	YES / widening wealth inequalities	Not sustainable because wage and tax policies are likely to be corrective
The "Digital divide"	YES / unequal access to digital	Not sustainable because corrective actions likely
Education	YES especially in the United States	Sustainable without corrective actions
Globalisation		
Advanced countries vs. emerging countries and developing countries	Redistribution of growth and wealth in favour of emerging countries and developing countries	A persistent factor
indebtedness		
Mountain of debt	YES but is it a cause or consequence?	Durable… and a large part of deleveraging still to come
Monetary policies		
Ultra-low rates and QE policies	YES but is it a cause or consequence?	Monetary policies that have come to an end

Q4 / How do you eventually get out of debt accumulation situations?

The level of indebtedness continues to be a problem because of the constraints on economic policies, but also because the real deleveraging is still yet to come. Some countries face a mountain of public debt (Japan and Greece are two good examples); for others, it is private debt that poses a problem (that of companies in China and Sweden, that of households and corporates in Denmark and Korea, for example), while others are constrained both by private debt and by public debt (Ireland, Spain, Portugal, Singapore). The only way to eliminate / reduce the risk premiums related to the solvency of states lies in the return of growth, the recovery of inflation, and the maintenance of low real rates. It is very difficult to have all this at the same time, and even more simply to have some of these conditions currently fulfilled: in the absence of such a configuration, five alternative solutions might emerge for some countries: 1) the default, 2) the restructuring, 3) the monetisation of the debt, 4) the continuation / implementation of asset purchase programs or 5) the pooling of debts, in the case of the euro zone for example. Such a decision would represent an additional leap towards federalism. In the current context, we can really doubt the leap to federalism, which amounts to focusing on the search for growth and maintaining a high ECB balance sheet for some time.

Q5 / Should geopolitical risks be permanently integrated?

A characteristic of the present and future period is the importance of political and geopolitical risks. These are so important and recurrent that they are now part of the natural landscape and must be integrated into portfolio construction as permanent risks. The rise of protectionism and more generally of "populism" is not a minor or isolated phenomenon, and all the more so because inequalities between countries, and within countries, have widened considerably. With the rise of emerging economies (China and Russia in the lead), **new types of international relations are also emerging, with a shift in economic and political power** to these economies. Since the beginning of 2010, global trade and, more generally, globalisation have been victims of this new balance. Can this (should it?) be extrapolated?

In the long term, several scenarios emerge, with two extreme situations: 1) a tendency to self-centrism or 2) greater international cooperation. We have been witnessing for some years now rising tensions between and within states (Spain and Catalonia the most recent example). The combination of state tensions and terrorist risks is giving rise to a fragmented and defensive world, with states seeking to protect themselves from external problems, thus forming "islands" in an ocean of instability. Growing self-centrism would reinforce the downturn in world trade and weak growth, and hence interest rates. Greater international cooperation would be likely to give greater impetus to growth. The second scenario is, by far, the most favourable.

Q6 / What scenario for the coming years?

For the years to come, it seems reasonable to us to bet on the following situation:

- **Lower structural growth than before the Great Financial Crisis**;
- Low inflation, but which is gradually becoming more of a concern, because of the sharing of value added (employees versus shareholders), **the end of the disinflation / deflation** exported by China whose role and influence are still changing... etc...;
- Higher interest rates than today, but which remain low by historical standards (**the current economic equilibrium justifies lower equilibrium rates than before**);
- That being said, the stronger growth environment, the probable rise in inflation and inflation expectations, the gradual end of central bank asset purchase programs... all this calls for **a rise in short-term and long-term interest rates**. Even if this increase will be moderate, except for a major shock, this seems to us to be **the tendency for the next years**;
- **Maintaining political and geopolitical risks at high levels**, with tensions (and crises) remaining permanent phenomena;
- An environment marked by **immense transformations**: megatrends, technological disruptions...
- **Significant underlying risks**: the current low volatility, very low rates, tight credit spreads, valuations sometimes considered excessive... all this indicates that a correction phase (probably a significant one) will necessarily occur in the coming quarters or years. **The financial markets live periodically in phases of complacency... we are currently in one of them.**

Expected Returns – short term and long term perspectives

DELPHINE GEORGES, Multi-Asset Strategy
VIVIANA GISIMUNDO, Deputy Head of Institutional Advisory

Cash

The expected returns from rolling an investment in cash over the different holding periods are derived from Amundi's projected trajectory of policy rates over the medium- to longer-term. In the eurozone, the nominal expected return on cash over 10 years is low at 0.8%, being very much influenced by the difficulty in normalising inflation and by a cautious view about the long-term growth prospects. Amundi's monetary policy trajectory is derived from the estimation of an equilibrium real policy rate (defined as the real rate consistent with full employment and stable inflation in the medium-term) and from the projection of a normalisation path toward that equilibrium real rate. In the eurozone, we consider a neutral real rate at -1% since 2009 (approximately equal to ECB estimates) versus 1% before 2009 and we make the assumption of 0% in the longer-run. Regarding the start of the normalisation of interest rates towards neutral rates, a Taylor rule would point to a first rate hike in early 2019 based on the ECB's economic projections and our equilibrium rate estimate. The last step of the estimation is to incorporate an inflation forecast, our projection is 1.7% over 10 years in the eurozone and 2% in the US.

Bonds

Our framework projects 10Y US Treasuries to return 2.6% over the next decade, while eurozone government bonds should return 1.2% per annum, a low nominal return given extended valuations and depressed starting yields. Those assumptions are based on a scenario of a moderate rise in bond yields. Building on the expected path for short-term real rates over the medium- to longer-term, we derive our bond yield forecasts adding the expected inflation over the holding period and a nominal term premium which is assume will remain low, leading to moderate rises in bond yields in our scenario. The term premium corresponds to the additional return that investors demand to hold a long-term bond as opposed to rolling over a short-term bond, and can be broken down into the inflation premium and the real term premium. In Amundi's view, both of these will remain fairly moderate in our projected environment of low real rates and inflation.

Credit

Expected returns on corporate bonds remain low both in the eurozone and the United States, as they are being hampered by an environment of low risk-free rates and tight spreads. In our framework, USD IG should return 3.6%

	Amundi Research Forecasts		
	Current level	**1-year Forecast**	**Long term equilibrium level**
Short Rates			
US	1.25%	2.0%	2.8%
Euro	-0.3%	-0.3%	1.7%
Government bond yields			
US 10y	2.33%	2.7%	3.5%
UK 10y	1.26%	1.3%	2.7%
Japan 10y	2.50%	0.0%	1.1%
German 10Y	0.33%	0.9%	2.4%
Spread vs German bond yields			
France 10Y	23	40	50
Italy 10y	136	140	130
Spain 10y	116	100	80
Spreads on Credit Investment Grade			
Investment Grade Euro	87	90	105
Investment Grade US	104	110	130
Spreads on High Yield			
High Yield Euro	238	260	350
High Yield US	357	390	450

p.a. over 10 years, while EUR IG should achieve 1.3% p.a., all below historical averages and close to all-time lows. As a result, the credit premium will be moderate going forward: the excess return versus government bonds is projected to be 1% for USD IG versus Treasuries and 0.7% for EUR IG versus German bonds.

Equities

We project a rewarding risk premium (i.e. excess return versus bonds) for eurozone equities despite higher uncertainty regarding the macro outlook as investors question whether the current environment is cyclical or structural in nature. The valuation of eurozone equities is attractive versus government bonds; in addition, over the next three years, we anticipate outperformance by eurozone equities as we expect them to be supported by an improvement in corporate profitability. US equities should deliver a return close to the historical average but their excess return versus bonds is less attractive as US rates have pulled higher and US equities have outperformed while Europe has lagged. Expected returns on Japanese equities continue to be dragged down in absolute terms by low income returns and low inflation.

Asset Name	Expected returns			
	1-Year	3-Years	5-Years	10-Years
Assets in local currency				
Long Term Government Bonds				
US 10y	-0.3%	1.0%	1.5%	2.6%
UK 10y	4.4%	1.5%	1.5%	1.4%
Japan 10y	0.8%	0.0%	0.2%	0.2%
US Bond-JPMTUS Index	0.3%	0.6%	1.7%	2.7%
Euro hard core/Germany	-4.1%	-1.8%	-0.5%	0.6%
Euro semi core/France	-4.4%	-1.8%	-0.3%	1.0%
EMU Bond - Core-JPMTWG index	-3.6%	-1.9%	-0.7%	0.4%
Italy 10y	-2.8%	0.2%	1.0%	1.9%
Spain 10y	-2.1%	0.5%	0.9%	1.8%
Euro Peripheral	-2.5%	0.3%	0.9%	1.8%
Eurozone*	-2.9%	-0.8%	0.2%	1.2%
EMU Bond - Periphery-JPMTIT index	-1.1%	0.5%	0.7%	2.0%
EMU Bond AM *-JPMGEMUI Index	-2.3%	-0.7%	0.0%	1.3%
Barclays Global Treasury*	-0.1%	0.3%	0.8%	1.3%
Cash				
Euro	-0.3%	-0.1%	0.3%	0.8%
US	1.7%	2.0%	2.2%	2.6%
Credit Investment Grade				
Investment Grade Euro	-2.1%	-0.9%	-0.5%	1.3%
Investment Grade US	0.1%	0.4%	2.6%	3.6%
Barclays Euro Aggregate	-2.7%	-0.8%	0.1%	1.1%
Barclays US Aggregate	0.4%	1.0%	2.1%	3.0%
Barclays Global Aggregate	-0.1%	0.4%	1.2%	1.9%
High Yield				
High Yield Euro	-0.8%	0.1%	0.0%	1.9%
High Yield US	1.8%	2.3%	2.3%	3.7%
Emerging Market Debt				
Hard Currency Debt	1.2%	2.6%	4.0%	5.5%
Equities				
US	5.1%	5.3%	6.0%	6.0%
Europe	9.1%	8.5%	6.5%	6.5%
Eurozone	9.6%	9.2%	6.5%	6.5%
UK	8.2%	7.2%	6.5%	6.5%
Japan	7.1%	5.2%	4.7%	4.7%
Pacific ex-Japan	7.0%	7.9%	8.3%	8.3%
Emerging Markets	8.0%	8.5%	9.3%	9.3%
World	6.2%	6.1%	6.1%	6.1%

**Eurozone Index and Global treasury Index are 7-10Y indices with a lower duration than the 10Y pilars, that's why the result here is not lower*

Macroeconomic and Financial Forecasts

Strategy and Economic Research

GDP and Inflation forecasts	GDP growth (YoY%)			Inflation (CPI, YoY%)		
	2016	2017	2018	2016	2017	2018
US	**1.5**	**2.2**	**2.1**	**1.3**	**2.1**	**2.0**
Japan	**1.0**	**1.5**	**1.2**	**-0.1**	**0.4**	**0.6**
Eurozone	**1.8**	**2.2**	**2.0**	**0.2**	**1.5**	**1.3**
Germany	1.9	2.5	2.0	0.4	1.7	1.6
France	1.2	1.8	1.6	0.3	1.2	1.6
Italy	0.9	1.6	1.3	-0.1	1.3	0.9
Spain	3.2	3.0	2.4	-0.2	2.0	1.2
UK	**1.8**	**1.5**	**1.2**	**0.7**	**2.6**	**2.5**
Brazil	**-3.6**	**0.7**	**1.9**	**8.7**	**3.5**	**3.9**
Russia	**-0.2**	**1.6**	**1.8**	**7.0**	**3.8**	**3.7**
India	**7.1**	**6.4**	**7.2**	**4.5**	**3.2**	**4.1**
Indonesia	**5.0**	**5.1**	**5.3**	**3.5**	**3.8**	**3.7**
China	**6.7**	**6.8**	**6.5**	**2.0**	**1.5**	**2.4**
Turkey	**3.2**	**5.1**	**3.9**	**7.8**	**11.0**	**9.5**
Developed countries	**1.6**	**2.1**	**1.9**	**0.7**	**1.7**	**1.6**
Emerging countries	**4.3**	**4.8**	**4.9**	**3.5**	**3.5**	**3.8**
World	**3.1**	**3.6**	**3.7**	**2.3**	**2.7**	**2.9**

Updated on 17 November 2017

Central Bank Rates forecasts

	End 2014	End 2015	End 2016	current	Amundi + 6m.	Consensus Q2 2018	Amundi + 12m.	Consensus Q4 2018
US	0.25	0.50	0.75	1.25	1.50	1.85	2.00	2.15
Eurozone	0.05	0.05	0.00	0.00	0.00	0.00	0.00	0.00
Japan	0.10	0.10	-0.10	-0.10	-0.10	-0.10	-0.10	-0.10
UK	0.50	0.50	0.25	0.50	0.50	0.55	0.50	0.70
China	5.60	4.35	4.35	4.35	4.35	4.35	4.35	4.35
India	8.00	6.75	6.25	6.00	6.00	5.90	6.00	5.90
Brazil	11.75	14.25	13.75	7.50	7.00	6.85	7.00	7.00
Mexico	3.00	3.25	5.75	7.00	7.00	6.95	7.00	6.35
Russia	17.00	11.00	10.00	8.25	7.50	7.40	7.00	7.00
Turkey	8.25	7.50	8.00	8.00	8.00	8.00	8.00	8.00
South Africa	5.75	6.25	7.00	6.75	6.75	6.55	6.75	6.55

Source: Amundi Research

Amundi ASSET MANAGEMENT

2 y. bond yield forecasts										
	End 2014	End 2015	End 2016	16/11/2017	Amundi + 6m.	Consensus Q2 2018	Forward + 6m.	Amundi + 12m.	Consensus Q4 2018	Forward + 12m.
US	0.63	1.04	1.18	1.71	**1.80/2.00**	2.00	1.89	**2.00/2.20**	2.29	1.97
Germany	-0.08	-0.34	-0.80	-0.71	**-0.60/-0.40**	-0.56	-0.65	**-0.40/-0.20**	-0.36	-0.57
Japan	-0.03	-0.05	-0.19	-0.19	**-0.20/-0.00**	-0.09	-0.16	**-0.20/-0.00**	-0.07	-0.13
UK	0.51	0.65	0.08	0.49	**0.40/0.60**	0.70	0.54	**0.40/0.60**	0.88	0.60

10 y. bond yield forecasts										
	End 2014	End 2015	End 2016	16/11/2017	Amundi + 6m.	Consensus Q2 2018	Forward + 6m.	Amundi + 12m.	Consensus Q4 2018	Forward + 12m.
US	2.17	2.27	2.45	2.36	**2.40/2.60**	2.70	2.45	**2.60/2.80**	2.89	2.52
Germany	0.54	0.63	0.11	0.39	**0.60/0.80**	0.74	0.55	**0.80/1.00**	0.96	0.68
Japan	0.33	0.25	0.05	0.05	**0**	0.07	0.12	**0**	0.08	0.17
UK	1.76	1.96	1.24	1.30	**1.20/1.40**	1.52	1.44	**1.20/1.40**	1.69	1.54

Exchange rates forecasts vs USD								
	End 2014	End 2015	End 2016	16/11/2017	Amundi + 6m.	Consensus Q2 2018	Amundi + 12m.	Consensus Q4 2018
EUR/USD	1.21	1.09	1.05	1.18	1.20	1.19	1.22	1.22
USD/JPY	119.9	120.3	116.6	113	115	114	117	112
GBP/USD	1.56	1.47	1.24	1.32	1.26	1.30	1.28	1.32
USD/CHF	0.99	1.00	1.02	0.99	1.00	0.98	0.98	0.97
USD/NOK	7.50	8.85	8.61	8.20	7.83	7.80	7.54	7.44
USD/SEK	7.83	8.43	9.08	8.41	7.92	7.86	7.54	7.41
USD/CAD	1.16	1.39	1.34	1.28	1.25	1.24	1.20	1.22
AUD/USD	0.82	0.73	0.72	0.76	0.72	0.78	0.70	0.80
NZD/USD	0.78	0.68	0.70	0.69	0.70	0.71	0.70	0.73

Exchange rates forecasts vs EUR								
	End 2014	End 2015	End 2016	16/11/2017	Amundi + 6m.	Consensus Q2 2017	Amundi + 12m.	Consensus Q4 2017
EUR/USD	1.21	1.09	1.05	1.18	1.20	1.19	1.22	1.22
EUR/JPY	145.08	130.68	123.02	133	138	136	143	137
EUR/GBP	0.78	0.74	0.85	0.89	0.95	0.92	0.95	0.92
EUR/CHF	1.20	1.09	1.07	1.17	1.20	1.17	1.20	1.18
EUR/NOK	9.07	9.62	9.08	9.66	9.40	9.28	9.20	9.08
EUR/SEK	9.47	9.16	9.58	9.90	9.50	9.35	9.20	9.04
EUR/CAD	1.40	1.51	1.41	1.50	1.50	1.48	1.46	1.49
EUR/AUD	1.48	1.49	1.46	1.55	1.67	1.53	1.74	1.53
EUR/NZD	1.55	1.59	1.51	1.72	1.71	1.68	1.74	1.67

Source: Amundi Research

Notes

Notes

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Editor: Philippe Ithurbide

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Contributors

AINOUZ Valentine, Credit Strategy
ALLIER Marie-anne, Head of Euro Fixed Income
ARIAS Pedro Antonio, Global Head of Real & Alternative Assets
ARIE Shinichiro, CFA, Head of Fixed Income Japan
BERTINO Claudia, Head of Amundi Investment Insights Unit
BERTONCINI Sergio, Credit Strategy
BLANQUÉ Pascal, Group Chief Investment Officer
BOROWSKI Didier, Head of Macroeconomic Research
BOSCHER Romain, Co-Head of Equities
BRARD Eric, Head of Fixed Income
CROSNIER Laurent, Head of Global Fixed Income
DEFEND Monica, Head of Strategy, Deputy Head of Research
DELBÒ Debora, Equity Strategy
DI SILVIO Silvia, Fixed Income and FX Strategy
DRUT Bastien, Fixed Income and FX Strategy
FIOROT Laura, Deputy Head of Amundi Investment Insights Unit
FORTES Roberta, Fixed Income and FX Strategy
FRANZIN Diego, Co-Head of Equities
GEORGES Delphine, Multi-Asset Strategy
GERMANO Matteo, Head of Multi-Asset
GISIMUNDO Viviana, Deputy Head of Institutional Advisory
GON Abhishek, Fixed Income and FX Strategy
ITHURBIDE Philippe, Global Head of Research
LICCARDO Giovanni, Investment Insights Unit Specialists
MIJOT Eric, Equity Strategy
MORTIER Vincent, Deputy Group Chief Investment Officer
PIRONDINI Marco, Head of Equities, US
PORTELLI Lorenzo, Multi-Asset Strategy
RATTO Mauro, Head of Emerging Markets
TAUBES kenneth J., CIO of US Investment Management
TROTTIER Laurent, Global Head of ETF, Indexing, Smart Beta Management
WANE Ibra, Equity Strategy

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ITHURBIDE Philippe, Global Head of Research

Deputy-Editors

BOROWSKI Didier, Head of Macroeconomic Research
DEFEND Monica, Head of Strategy, Deputy Head of Research

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