Confidence must be earned

Amundi
ASSET MANAGEMENT

CROSS ASSET

INVESTMENT STRATEGY

CIO VIEWS

LICENCE FOR VALUE HUNTING

THIS MONTH'S TOPIC

FED "QUANTITATIVE TIGHTENING" IS CLOSE TO ITS END
GOD BLESS QE!

Research & Macro Strategy

Document for the exclusive attention of professional clients, investment services providers and any other professional of the financial industry

CIO VIEWS

Licence for value hunting

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

If an investor had woken up today after three months and looked at the markets, he/she could reasonably say that not much had changed. The year started on strong footing and **risk assets experienced a massive rebound in the first weeks of 2019**, erasing most of the losses experienced in one of the most awful Decembers in history. As a result **some valuation gaps have been closed somewhat, though not exhausted**. Markets switched rapidly from a "fear" to a "greed" mood. Catalysts of the renewed optimism have included the dovish shift in the Federal Reserve's strategy, and increasing signs of progress in the trade negotiations between the US and China.

So, something has changed. A year ago, the narrative was about synchronised growth, inflation returning to the radar screen, and higher rates. In the second half of 2018, the scenario changed, however, featuring a synchronised slowdown and almost no signs of inflation risk. Going forward, we expect further **divergences through the year**: the US will continue to decelerate (from strong growth), EM could stabilise and rebound in H2, with differences among countries, and the Eurozone could follow, with stabilisation and rebound in H2, if significant risks don't materialise. So, **we are now in a sweet spot** (slowdown but no recession, central banks on pause mode or accommodative stance, core bond yields stable at low levels) and as long as this continues (ie as long as growth does not falter too much or alternatively the Fed is back to focusing on inflation or growth concerns), this spot is market-friendly, though we are likely to see volatility as some areas of uncertainty (geopolitics) and vulnerability (high debt) persist.

The guiding principle for navigating this late phase of the cycle is the consistent **search for sustainability from different perspectives**. Focuses include the following: **sustainability of growth –**ie, countries/areas with solid domestic sectors. It is particularly important in EM countries to avoid situations of excessively unbalanced and vulnerable growth models, preferring areas that are experiencing a rise of internal demand (Asia in particular); **sustainability of corporate earnings**, focusing on companies with solid business models; and **sustainability of debt**, avoiding the most fragile situations, which could suffer the most in phases of scarce market liquidity.

We strongly believe that focusing on fundamentals will prevent investors from **falling into the pessimism (and/or excess of optimism) trap** that a noisy news flow could trigger (trade disputes still in the radar screen and CBs communications). Following this sort of focus will also help in identifying market areas that could offer value for long-term investors. In January, we saw opportunities to increase risk exposure, starting with EM and credit (now partially exploited). We are now closely monitoring **European equities** which could now be an investor focus again. It is true that economic momentum remains weak, but further fiscal impulses could help stimulate domestic demand and a re-acceleration in EM growth could also benefit Europe. Earnings revisions reflect the pessimism associated with a slowdown, but we now see signs of deceleration in negative revisions, a signal that we are likely moving past the pessimism. Valuations are not discounted as they were at the beginning of the year, but they are not expensive either, with areas of opportunities in some cyclical sectors (i.e in industrials). Investors should not yet be in a hurry, but there could be reasons for deploying capital in European equities during the year, and we don't believe there is cause to be short now on this asset class.

In conclusion, as we expect the market mood to continue to swing between fear and greed, we see some room for rotation to quality, reduction of directional market exposure or tactical recalibration of the risk budget. With a medium-term view, in a world of low yielding risk-free assets, the key guideline is to try to hunt for value opportunities arising from cyclical fluctuations.

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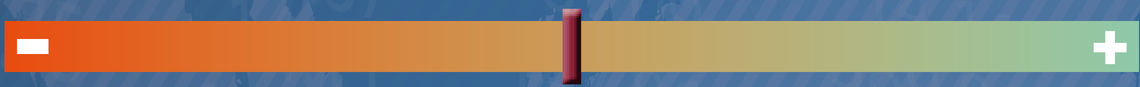
Overall risk sentiment

Risk off **Risk on**



Cautious risk assessment, close to neutral,
reduced vs previous month after the strong market rebound

Changes vs previous month

- Some profit taking in credit
- Overall more cautious stance after the rebound

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

MACRO

What marks the end of monetary normalisation?

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

Global trade contracted sharply in 4Q18 (-3.6% annual rate). This contraction partly represents a return to the "more normal" levels set after the great financial crisis of 2008, while 2017 was just an abnormally high year. In fact, while the annual growth rate in global trade was around 6% in the period 1992-2007, this has moved down to around 2.6% since 2012 (while 2017 was very high at 5% annual growth). That said, the contraction in trade seen at the end of 2018 proved to be particularly extreme: indeed global trade was down by -1.4% yoy in December, a contraction unseen since 2009. In part, this could be due to the high level of uncertainty. In fact, in response to an uncertainty shock, firms potentially adjust their inventory policies by making disproportionately large cuts to their orders of foreign intermediates.

If this is true, the soaring uncertainty induced by the fear of an escalation in the trade war between the US and China (uncertainty indices peaked in December) may explain the sharp fall in trade in the same month. Political uncertainty dropped in January, probably because of the perceived potential for an agreement being struck between the US and China. **It is likely that uncertainty will fall further in February, which, *ceteris paribus*, could help world trade to stabilise.**

However, other elements of uncertainty persist, especially in the short term in Europe. On the one hand, the risks around Brexit remains high, while on the other hand, Donald Trump may want to increase pressure on Europe by "demanding" measures to rebalance bilateral trade between the US and the Eurozone (with the automotive sector in focus). These issues could prove to be problematic, given the recent weakness in the Eurozone.

> "With recession unlikely in the near future, markets will be driven mainly by political developments and CB actions."

It is in this context that central banks have changed their communications:

- With respect to the **ECB**, the extent of the deterioration of the economic situation in the Eurozone has surprised the ECB, which no longer thinks that this is solely due to temporary factors. The ECB's growth forecasts will clearly be lowered. **In such conditions, the door for new TLTROs* is wide open** as the ECB wants to avert any further deceleration by supporting the bank lending activity;
- With respect to the **Fed**, several FOMC members openly stated doubts about the need to raise rates again. **"Wait and see" have become the watchwords.** In addition, the minutes confirm that the Fed intends to maintain a larger balance sheet than expected just few months ago. The resurgence of domestic (shutdown) and external (China, Eurozone, Brexit, trade tensions) risks is put forward to explain this turnaround. There are too many unknowns to continue monetary normalisation, especially as inflation remains contained and unit labour costs are declining.

Ultimately, support from central banks tends to reinforce our scenario: the shock should prove temporary, with domestic demand expected to remain solid (especially consumption) on both sides of the Atlantic.

** The targeted longer-term refinancing operations (TLTROs) are Eurosystem operations that provide financing to credit institutions for a predefined period of time. They offer long-term funding at attractive conditions to banks in order to further ease private sector credit conditions and stimulate bank lending to the real economy.*

DM= Developed Markets, EM = Emerging Markets, CB= Central Bank, ECB= European Central Bank, Fed= Federal Reserve.

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The Strategist view

Credit and peripheral bonds in demand

Peripheral bonds: January saw quite strong and successful new issuance activity on the part of the Italian Treasury, as Italy accounted for roughly 16% of overall gross issuance and 78% net issuance for the whole year: other peripheral countries were successful too in placing new debt. February started with another successful, oversubscribed, 30Y deal, but weighting in the secondary market, while the macro picture remains challenging.

Credit: January also saw one of the best monthly performance of the last years for both US and EUR HY, with most of the ground lost in Q4 being recovered. Technicals turned more supportive for EU spread products as: 1) the ECB turned dovish and is likely to deliver a new round of long term operations; 2) the fall in safe haven bond yields increased the relative attractiveness of spread products; 3) the search for yield should persist, especially in the 1-5Y, where 75% of debt has negative or flat yield to maturity; 4) positioning was quite light at the start of the year and inflows were back. The other side of the coin is that valuations now look to be more in line with fair values (though still attractive vs quite low equity implied volatility) while the macro slowdown intensified in the Eurozone.

A consolidation phase and a more carry-like return by spread products may now be expected on the back of recent strong tightening, less compelling valuations, and persisting economic slowdown. Short-term drivers are likely represented by developments on the political side together with the next steps in monetary policy to be taken by the ECB and the Fed.

MULTI-ASSET

Don't chase the bull

MATTEO GERMANO, Head of Multi-Asset

The strong bounce experienced by risk assets which followed the December meltdown has reduced many valuations gaps and stretched oversold conditions. We wonder if the rally is sustainable. **We believe this is not the time for chasing the bulls but rather for being selective and vigilant**, taking profit where the rebound has already materialised and getting ready to re-enter in areas where the repricing has not fully occurred yet. Our central case is for a decent but decelerating global economic growth, with slowing profit growth. Plus, there is a combination of high geopolitical risks and a number of idiosyncratic risks, which increase the uncertainty on the policy reaction front. These factors are today tamed by the more dovish attitudes of CBs, which will help to further extend the late cycle, and will allow the persistence of **favourable conditions for selected risk assets (credit, selected EM stories).** Given the fragile balance at play, we would stress the need to be vigilant, in a framework of cautious optimism.

High conviction ideas

Global profit cycle has passed the peak although we still expect single digit growth in 2019. Revenues will be a key factor regarding global equity returns performance. We prefer to keep an overall defensive bias, with a focus on diversification among regional equities, and on the value factor. We **favour Japan equity**, as the market still offers attractive valuations after the December correction, and light investor positioning, and it is a bit more sheltered from geopolitical tensions (trade disputes in particular).

On EM equity, valuations are not as appealing as at the beginning of the year, but the sentiment is **still moderately in favour of EM**. We are particularly **positive on China**, where there is a better policy space (monetary and fiscal) that in many other EM, plus it is more domestically oriented and valuations are still moderately attractive.

> "Given the fragile balance at play, it is time to stay vigilant, take profit in areas that have already outperformed and look for further entry points."

In **credit**, the recent spread compression across the board has been material and valuations have become less attractive compared to the beginning of the year. We prefer to **lighten part of the credit position for tactical profit taking** but the outlook remains positive: the envivornment of low growth (but limited recession risks) and low rates is favourable for carry trades and investors' appetitie is high. We favour EU credit vs US credit, due to better technical and fundamental features.

Our overall **view on duration is neutral**, waiting for better entry points to become more aggressive on the Treasury market. The picture remains very fluid for taking strong views on the yield curve, but we expect some slight flattening pressure to persist.

We maintain **a preference for US versus German bonds** (on the 5 year) and we plan to increase it with a medium term investment perspective as better entry levels materialize.

On currencies, we believe the USD will continue to be supported in the short term – weak growth in Europe and EU political risks at the forefront – but we expect to see some weakening trends later in the year as the Fed moves close to its target. We remain constructive on the NOK, and cautious on the GBP (against both the EUR and USD), due to the still uncertain Brexit outcome, and we are positive on the JPY.

Risks and hedging

We continue to suggest **gold and yen exposure as hedges**. Gold could also benefit from a more dovish Fed stance.

NOK = Norwegian krona , GBP = British Pound, EUR = Euro, USD = US dollar, JPY = Japanese yen.

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Amundi Cross Asset Convictions

	1 month change	---	--	-	0	+	++	+++
Equities vs bonds					■			
Credit	↘					■		
Duration					■			
Oil					■			
Gold						■		
Euro cash				■				
USD cash						■		

The table above represents cross asset assessment on a 3-6 month horizon, based on views expressed at the most recent global investment committee. The outlook, changes in outlook and opinions on the asset class assessment reflect the expected direction (+/-) and the strength of the conviction (+/++/+++). This assessment is subject to change.

FIXED INCOME

Carry is your friend

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

The U-turn in central bank policies will likely prevent any material increase in long-term rates. Markets priced out previously expected Fed hikes and are now focusing on the changing stances of all main DM and EM central banks which are becoming more accommodative across the board. The new CB mood should support sentiment for risk assets (credit and EM), keeping the search for yield alive among investors, though the focus should now be on appealing carry opportunities, after the strong spread compression.

DM bonds

On US bonds, we have an overall **neutral view on duration**, given the Fed's greater policy flexibility and the potential for an early end to the balance sheet taper. On a global perspective, we are **more positive on the US, neutral on the UK, and less negative on the Eurozone**, as we don't expect to see further downside in yields from current levels. We confirm our negative bias on Japan. We also continue to be positive on inflation linked bonds, in particular in the US. In Euro fixed income markets, we are **more constructive on peripheral countries** with some opportunities in Italy and we continue to exploit curve opportunities (i.e. playing the 2-30 year differential in Germany).

> "The U-turns in CB tones have pushed investors back towards the search for yield. It is time to focus on carry and fundamentals, after the strong spread compression."

Credit

Credit has been a big beneficiary of the rally and the valuation reset was very fast in January. Therefore, we have **become more cautious in the short term**, though we believe that credit remains a key yield engine for bond investors. In **Euro credit**, we keep our preference for subordinated debt financial. In **US credit**, after becoming more positive at the end of 2018 when credit spreads widened, we are now maintaining our stance. We focus on investment ideas in bonds that may not have fully participated in the rally, and at the same time we are taking profits in the areas that now appear to be fully valued. We remain wary of bonds from issuers with higher leverage than is appropriate for their credit rating. We continue to believe that structured credit sectors – specifically non-agency MBS, CMBS and ABS – may offer relative value to investors backed by a strong US consumer, and by the superior credit protections they offer relative to their quality ratings.

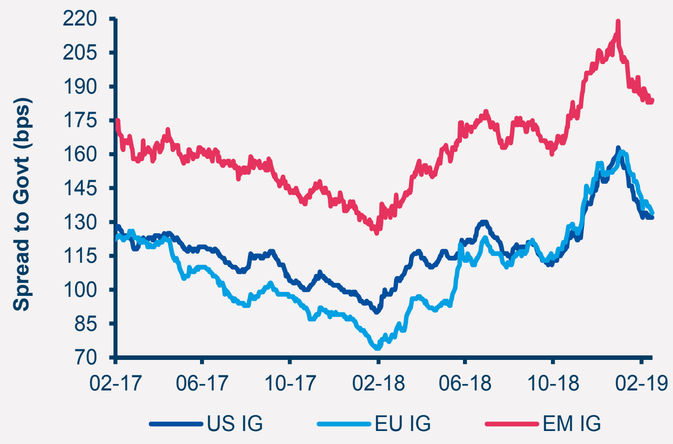
EM bonds

The start of the year saw an improvement in sentiment regarding EM debt. We expect that a more dovish tone by the Fed (and by other CB), a benign inflation outlook in most EM countries, and a stabilisation of economic **conditions will continue to favour the asset class** in 2019. On EM hard currency debt, we expect returns in line with the carry, while **EM bonds in local currency may offer higher return potential**, with many EM currencies still undervalued, albeit at higher volatility. We think investors should improve the quality of their portfolios, as risks persist (slowdown and trade).

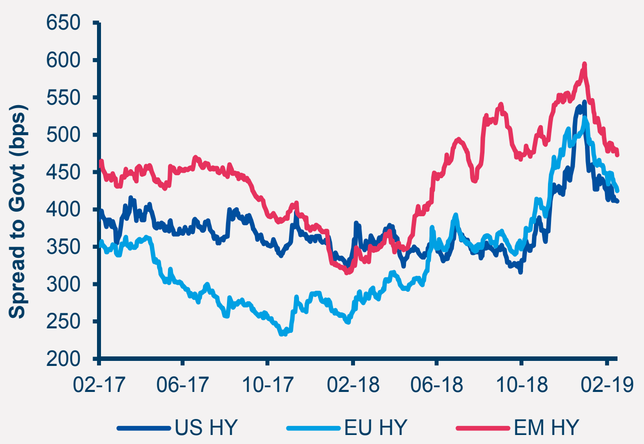
FX

On **USD**, we have a neutral view due to the more dovish Fed. We are turning more **cautious on the Euro** amid a weak economic momentum (prefer SEK & NOK) and **neutral on the GBP** given Brexit uncertainty. We are positive on **JPY** (safe heaven in case of turmoil) and we favour **EM FX** with room for further appreciation.

IG credit spreads



HY credit spreads



Source: Amundi, Bloomberg. Data refers to ICE BofAML Bond Indices, as at 20 February 2019. EU IG: Euro Corporate Index; US IG: US Corporate Master Index; EM IG: IG EM Corp Plus Index, US HY: US High Yield Master II Index, EM HY= High Yield EM Corporate Plus.

EQUITY

Take a breath

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

Overall assessment

The equity rebound has come on fast and we can reasonably now expect the markets to take a breath. Going forward, the focus will be on earnings growth. This has been revised down materially across the board, **and the market is overall more vulnerable, being in a late cycle**. However, in a central scenario of no recession, earnings growth should remain positive globally, with opportunities opening at regional/ sector and stock levels. Investors should be aware of potential vulnerabilities (slowdown, geopolitical risks), but at the same time exploit the opportunies that some price dislocation can open, as it happened in Q4.

DM Equities

In the US, there are really no meaningful warning signs or excesses in the market that usually precede a recession or bear market. In Q4 earnings season, companies have generally announced earnings that are stronger than low investor expectations, but the number of companies revising down expectations is the highest since 2016, and the deterioration in earnings revisions should be a focus. We still like the more cash-generative tech companies with solid competitive positions. We also like value and cyclicals with the lowest valuations. We are cautious on traditionally defensive sectors both in value (utilities) and growth (staples). European equities were neglected last year, but bounced back in 2019, but there is still likely an excessive pessimism regarding this asset class. In our view, there is not a strong case to remain too short: political uncertainty is high, but may well fall after a Brexit resolution and EU elections.

Earnings revisions reflect the pessimism of the slowdown, but we now see signs of deceleration in negative revisions, a sign that the worst may now be behind us. Valuations are not as discounted as they were at the start of the year, but they are still attractive. Within an overall balanced approach, we continue to favour cyclicals over defensives, with some pockets of cyclicals pricing in a recession, which is not our base case. For banks, a catalyst is needed (relief of the political uncertainty or new accommodative measures from the ECB) for the sector to be back in favour.

Valuations and fundamentals are attractive for **Japanese equities**, but with some risks (dollar strength and vulnerability to exports).

"We still see positive earnings growth this year, but after the rebound, valuations are less attractive. Focus on sustainability of earnings is key in a late cycle."

EM Equities

We remain constructive on EM equities although in the short term there could be a pause after the rebound.

Positives for the asset class include the widening expected growth differential, attractive valuations vs DM, improving capital expenditure discipline, no major macroeconomic imbalances, and decent earnings growth (with country/sector differences).

We like countries with resilient macroeconomic fundamentals and domestic growth drivers, strong reform agendas and attractive valuations. We also like countries with favourable monetary and fiscal room and low external vulnerabilities. Our most preferred markets are China, India and Indonesia in Asia; we favour Russia in CEEMEA (as sanctions have been partially discounted) and Argentina in Latam.

We are cautious on countries with expensive valuations and high political risk.

Equity markets performances (% over 1 year)

Source: Amundi, Bloomberg. Data from 20/2/2018 to 20/2/2019. EM index in USD.

Amundi asset class views

	Asset Class	View	1M change	Rationale
EQUITIES	US	+		Earnings decelerated in Q4 and expectations for 2019 have been revised down. On the positive side, valuations are not expensive and could still support the asset class with a medium-term perspective. In the short term, after the sharp rebound, some consolidation is expected.
EQUITIES	Europe	=		Market positioning still does not favour this asset class given a weak economic scenario, downward earnings revision and political uncertainty. However, much bad news already looks to be priced in, except a no deal Brexit and an aggressive trade policy from the US administration. We have a neutral view and we could see some opportunities ahead.
EQUITIES	Japan	+		The market is still cheap after the December rebound. However, export-led companies exposed to global growth could be negatively affected by the weak global growth momentum. It is important to look at the currency: excessive JPY strengthening is a negative for the market and has to be carefully monitored.
EQUITIES	Asia-Pacific ex Japan	=		The market is highly sensitive to the commodity cycle. We are neutral at this stage, as more visibility on China spending on infrastructure is needed to take a more positive view.
EQUITIES	Emerging markets	+	▼	We remain slightly positive in the short term, but we could see some consolidation after the rebound. For the remainder of the year, we would focus on earnings growth and the evolution of the economic cycle. China among favourite picks.
FIXED INCOME	US govies	+		We have a constructive view on US govies benefitting from the CB's dovish stance and decelerating economic figures (from strong data). US bonds look attractive as hedging strategies and for liquidity features.
FIXED INCOME	US IG Corporate	=		A dovish Fed (rate normalisation target closer) and a still-supportive macro picture could continue to sustain the segment, but after the sharp rebound, we see less support from valuations.
FIXED INCOME	US HY Corporate	=	▲	With spreads having recovered from the end-of-year sell-off, we see a more carry-like return for the asset class. Some opportunities may be found in bonds that may not have fully participated in the credit rally, while we are more cautious on names that rallied and appear fully valued. Focus on sustainability of debt.
FIXED INCOME	European govies	=		Limited upside for core government bond yields and unattractive valuations. Pockets of value can be found playing yield curve movements. Slightly more positive on Euro Peripheral Bonds (vs 1 month ago) and neutral in UK govies.
FIXED INCOME	Euro IG Corporate	+	▼	The outlook is still constructive, but we are more cautious now after the rebound. Valuations are less attractive than just one month ago and closer to fair values and we expect technical conditions to be less supportive. We see still some upside potential linked to ECB March meeting.
FIXED INCOME	Euro HY Corporate	+		Valuations are less compelling than just one month and closer to fair values, consistent with current leading macro indicators. Leverage is still low and default rates are likely to stay low in the next 12 months. We suggest playing the asset class as a carry story, while spread compression is expected to be limited.
FIXED INCOME	EM Bonds HC	+	▼	More accommodative Central Banks are supportive for the asset class. Recent rebounds make valuations less appealing. Short-term volatility could re-open opportunities to gradually add to the asset class. Attractive carry.
FIXED INCOME	EM Bonds LC	++		We remain constructive on the asset class, due to the positive support that should come from EM FX, still undervalued and supported by the expected depreciation in the USD. Moreover, the real rates differential is still in favour of EM vs DM.
OTHER	Commodities			We revised down our oil targets to USD 55-65 and USD 60-70 for WTI and Brent, respectively. Negative economic momentum and a dovish Fed are again providing support for gold, which could remain a reasonably efficient hedge this year.
OTHER	Currencies			The USD is likely to continue to be supported in the short run, but it should weaken in the coming quarters, as the Fed is close to its rate target. The strong USD appreciation in 2018 doesn't reflect fundamentals, with the result that the currency is overvalued vs the G-10 universe. We are neutral on the GBP, amid Brexit uncertainty, and positive on the JPY, on expected repatriation of flows.

LEGEND

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	Negative		Neutral		Positive		Downgrade vs previous month	Upgraded vs previous month

Source: Amundi, as of 19 February 2019. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research, investment advice or a recommendation regarding any fund or any security in particular. This information is strictly for illustrative and educational purposes and is subject to change. This information does not represent the actual current, past or future asset allocation or portfolio of any Amundi product.

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

THIS MONTH'S TOPIC

Fed "quantitative tightening" is close to its end God bless QE!

BERTONCINI SERGIO, Head of Rates & FX Research

Finalised on 25/02/2019

The essential

As is widely known, Fed communication has moved significantly towards a much more dovish tone in the past two months. The change in communication has been twofold, both on rates (the Fed became "patient" and "flexible" on the rate outlook) and on prospects for the so-called quantitative tightening (no longer any "autopilot" in balance-sheet runoff). In this piece we focus on the second tool of Fed policy, analysing rationales and targets behind balance sheet normalization, which have been detailed and widely expressed in recent Fed communication released by Chairman Powell, other Fed governors and the minutes of the January FOMC meeting. An earlier end to "quantitative tightening" (QT) has become likelier, working in combination with a more dovish stance on rates.

The minutes from January FOMC meeting released on Wednesday confirmed the dovish stance of the US central bank. This was particularly the case for the so-called "quantitative tightening" (QT), as the minutes revealed that previous Powell statements about central bank balance sheet normalization were almost unanimously shared by Fed governors: "almost all participants thought that it would be desirable to announce before too long a plan to stop reducing the Federal Reserve's asset holdings later this year". In a nutshell, the Fed looks posed to end balance sheet normalization sooner than later, probably in late 2019 and with a final size looking much higher than pre-GFC levels. Fed members' view on rates looks more split between "several" policy makers stating that "if the economy evolved as they expected, they would view it as appropriate to raise the target range for the federal funds rate later this year", and others underlying that "rate increases might prove necessary only if inflation outcomes were higher than in their baseline outlook".

Powell addressed the QT issue at January FOMC

As widely known, Fed communication has moved significantly towards a much more dovish tone in the past two months. The change in communication has been twofold, both on rates (the Fed became "patient" and "flexible" on the rate outlook) and on the prospects for the so-called quantitative tightening (no longer any "autopilot" in the balance-sheet runoff). In short, the message on Fed strategy was quite clear: a "pause" on rates is closer, and the Fed has revised the QT outlook, as well. However, as we see it, in January the markets focused more on the change in the rate outlook, and details were lacking on the second point. In this respect, clearer indications on the process of balance sheet normalization came later, at the first FOMC meeting of 2019, by the end of the month. At that time, in our view, Fed chair outlined quite clearly Fed guidelines for managing the end of QT.

Powell sent three major messages on QT during the press conference following the January 30 FOMC meeting:

1. The ultimate size of the Fed's balance sheet will be calibrated on financial institutions' demand for reserves, plus a buffer. In Powell own words: "Settling this central question clears the way for the FOMC to address a number of further questions regarding the remaining stages of balance sheet normalization. The decision to retain our current operating procedure means that, after allowing for currency in circulation, **the ultimate size of our balance sheet will be driven principally by financial institutions' demand for reserves, plus a buffer so that fluctuations in reserve demand do not require us to make frequent sizable market interventions**."

2. The estimate of this reserve level is much higher size than the pre-GFC world and has increased considerably in the past year: **"Estimates of the level of reserve demand are quite uncertain, but we know that this demand in the post-crisis environment is far larger than before.** Higher reserve holdings are an important part of the stronger liquidity position that financial institutions must now hold. **Moreover, based on surveys and market intelligence, current estimates of reserve demand are considerably higher than estimates of a year or so ago. The implication is that the normalization of the size of the portfolio will be completed sooner, and with a larger balance sheet, than in previous estimates."**

3. At coming meetings, the issue will be addressed, and a decision could be taken and communicated. 2019, therefore, may mark not only the end of rate normalization, but also the year of the last leg of balance sheet normalization. "In light of these estimates and the substantial progress we have made in reducing reserves, the Committee is now evaluating the appropriate timing for the end of balance sheet runoff. **This decision will likely be part of a plan for gradually reaching our ultimate balance sheet goals while minimizing risks to achieving our dual mandate objectives and avoiding unnecessary market disruption. We will be finalizing these plans at coming meetings."**

The big question mark is obviously the likely target of the Fed: at the time of the latest FOMC meeting, the market consensus was already broadly pointing to a level of excess reserves in the USD 1tn area. This would be considered consistent with a balance sheet size close to USD 3.5/3.6 tn (down by around USD 400/500 bn from the current level of close to USD 4 tn).

In the Q&A following the press conference, Powell, understandably, did not ratify any number but seemed comfortable with consensus indications. This was the direct question posed to the chairman on this issue: "You (...) keep mentioning the market average or the market outlook for the size of the balance sheet. **Are you endorsing the market average, which is 3-1/2 trillion? And if you're not endorsing it, why do you keep mentioning it?"** Here is Powell's answer: "I'm not going to give our estimate or ratify anybody else's estimate of what the equilibrium balance sheet is here today. There are estimates out there but I'm not at a point today where I'm going to be giving out numbers on that. **But there are estimates and I think they're consistent with what I said, broadly speaking".**

Reference sources for targeted reserves on the Fed radar screen

Coming back to the chair's statements, the two most likely ***"Surveys and market intelligence"*** sources cited in his statement, which we reported in point 2) likely refer to: a) the **Senior Financial Officers Surveys** and b) the **Primary Dealers Survey** (run by the NY FED). Getting into more detailed messages from these two surveys, we report the main findings from both of them below:

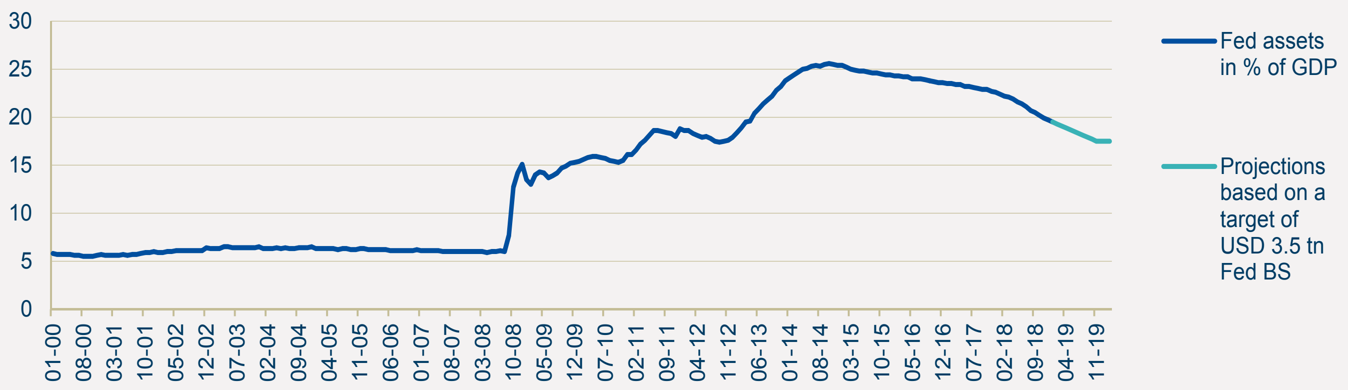
a.Senior Financial Officers Survey

In the September SFOS, a specific "question on lowest comfortable level of reserve balances" was put to banks:

"Senior financial officers at each bank were asked to report the approximate lowest level of reserve balances that they would feel comfortable holding before taking active steps to maintain or increase their bank's reserve balances given the prevailing constellation of short-term interest rates relative to the IOER rate."

"In aggregate, the lowest comfortable levels of reserve balances reported by all respondents summed to about $600 billion, a little less than half of these banks' average reserve balance holdings in August 2018. Recall that, in aggregate, **the respondent banks held roughly two-thirds of total reserve balances at the time of the survey.**"

1/ **Fed assets in % of GDP**



Source: Bloomberg, Amundi Research, data as of 25 February 2019

On the back of the latter statement, it is reasonable to infer that aggregate demand for reserves from the whole system should be close to USD 850/900 bn. Regarding the buffer Powell referred to at the latest FOMC meeting, a level of USD 100/150 bn is considered appropriate by the consensus: this would total around USD 1 tn amount for the overall reserves.

b.Primary Dealers Survey (run by the NY FED)

In a speech on MP normalization on October 26, 2018, NY Fed Simon Potter had already cited the September survey of primary dealers: "Our regular surveys give us a sense of how some market participants are viewing many of these components. In particular, the surveys ask respondents about their expectations for the size and composition of the Federal Reserve's balance sheet, on average, in 2025, under the assumption of no return to the zero lower bound. The responses serve as a good proxy for expectations about the long-run size of the balance sheet. The **median expectations are for the balance sheet to be $3.6 trillion on average in 2025** and for reserve balances to be $750 billion, or about $1 trillion below their current level."

This survey confirmed market consensus expectations close to a USD 3.5 tn in the long term, while a more recent survey added some color on the expected composition of the Fed's balance sheet, which should see a greater weighting of Treasuries vs MBS and a higher level of reserves, closer to USD 850 bn. It is interesting also to add that two years ago, former chairman Bernanke had already provided his guidance, quite in line with the current consensus. On January 26, 2017 he argued that "Taking into account growth in nominal GDP and bank liabilities, the critical level of bank reserves needed to implement monetary policy through a floor system seems likely to be well over **USD 1tn** today, and growing."

On the policy mix, Powell reiterated the "dominance" of rates over balance sheet:

"First, as we've long emphasized, **the federal funds rate is our active monetary policy tool**.

Second, as far as the particular details of normalization are concerned, we will not hesitate to make changes in light of economic and financial developments. This does not mean that we would use the balance sheet as an active tool, but occasional changes could be warranted.

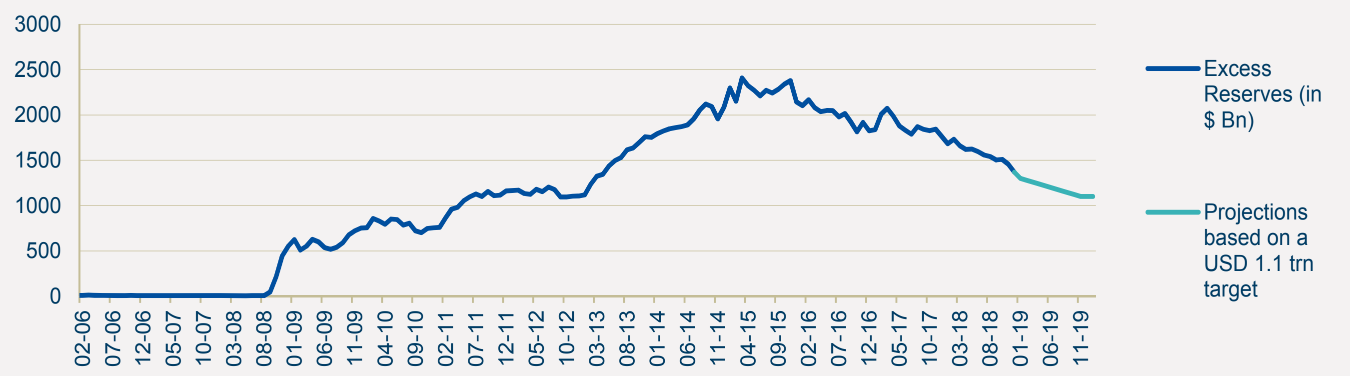
Third, we repeat a sentence of the normalization principles we adopted in June 2017. While the federal funds rate would remain our active tool of policy in a wide range of scenarios, we recognize that the economy could again present conditions in which federal funds rate policy is not sufficient. In those cases, the FOMC would be prepared to use its full range of tools, including balance sheet policy."

This looks very much consistent with previous indications from Fed officials on dynamics between rates normalization and balance sheet normalization: this was described in detail in the aforementioned speech of NY Fed Simon Potter, which is helpful for understanding Powel's latest statement, too.

"As the portfolio shrinks and the level of reserve balances declines, how will we know if we are transitioning from an environment characterized by abundant reserves to one characterized by scarce reserves? (...) At high levels of reserves, the responsiveness of rates to changes in reserve levels is fairly low, and the demand curve is said to be 'flat'. As excess reserve levels decline, the responsiveness of rates increases. At low levels of excess reserves, the overnight rate responds sharply to small adjustments in the level of reserves, and the demand curve is considered "steep."

"When overnight rates—including rates on federal funds transactions—edge higher, what tools does the Federal Reserve have to ensure that they generally remain within the target range when reserves are abundant? **The federal funds target range is an important feature of the FOMC's public communications, and maintaining control of**

2/ **US banks excess reserves (in US$ bn)**



Source: Bloomberg, Amundi Research, data as of 25 February 2019

the federal funds rate and other money market rates is therefore taken quite seriously. Public confidence in our ability to maintain rates within the target range is important for ensuring that expectations for the FOMC's future policy stance are properly incorporated into the term structure of interest rates, and thereby appropriately affect financial conditions and the broader economy."

In short, the calibration of the size of the balance sheet and the volume of excess reserves aim at keeping policy rates within the targeted range without unwanted volatility in short term rates, while the recourse to balance sheet policy would occur only if non-conventional tools were needed.

FOMC minutes and Fed speeches in February gave more clues about target and timing

Following Powell's statements, in February we had more clues on the balance sheet size target and the timing for the end of Fed QT. The main sources of new indications came both from speeches and from the release of the January FOMC minutes.

On the question about "**when**" QT is likely to stop, the FOMC minutes made it quite evident that we should expect 2019 to be the year that the runoff ends: **"Almost all participants thought that it would be desirable to announce before too long a plan to stop reducing the Federal Reserve's asset holdings later this year."** Furthermore, many pointed out that the decision and the statement that communication should arrive soon as **"before too long"** may refer to one of the next two FOMC meetings.

If the consensus is broad about the timing, the **targeted level** of reserves does not look so unanimous among Fed members. In their latest speeches Brainard, Clarida, Williams and Harker referred to a range between a minimum USD 1.0 tn and a maximum of USD 1.3 tn, therefore on average close to but actually even above the USD 1 tn level we mentioned before.

If Fed is going to stop draining liquidity when excess reserves fall to USD 1.1/1.2 tn, this would mean a level of Fed assets stabilizing at around 17% of GDP, as the chart shows, still quite high with respect to pre-GFC levels, at that time close to just 5%.

On the future composition of the Fed balance sheet, another relevant topic to be addressed despite representing more a medium- to long-term issue, the aforementioned latest survey of primary dealers showed an expected switch in favor of US Treasuries from current composition of QE portfolio. US Treasuries are expected to rise to 76% from the current 55%, and Agency MBS to fall to 19% from 40%. These trends in balance sheet composition look to be in line with recent Fed messages. Cleveland Fed President Loretta Mester, for example, on composition said, "My preference would primarily be Treasuries (...) And I would skew it towards short-term Treasuries (...) "It would be a shorter duration than this current balance sheet".

Regarding this topic, the very latest speech by the Fed vice-chairman for banking supervision, Randal Quarles, confirmed the preference for Treasuries: "I favor a return to a balance sheet with all Treasuries securities, allowing our mortgage-backed securities (MBS) holdings to run to zero." Also, the message of Quarles on duration also looks very much in line with the statement by governor Mester, quoted above, adding the rationale behind this view: "In regard to duration, **moving to shorten the duration of our holdings could increase the Fed's ability to affect long-term interest rates if the need arose**. However, it might be preferable to have the composition of our Treasury holdings roughly match the maturity composition of outstanding Treasury securities, minimizing any market distortions that could arise from our holdings."

Conclusion

On the year to date Fed communication has broadly indicated an earlier end for balance sheet run-off. In January, Chairman Powell outlined the rationale behind calibrating the size of the balance sheet and the need to consider the volume of excess reserves in order to keep policy rates within the targeted range without unwanted volatility in short term rates. Powell clearly mentioned that estimates of needed excess reserves have increased considerably in the past year. Minutes from latest FOMC meeting revealed that the view on an earlier end to QT is almost unanimous among Fed members. They also indicated that the central bank is likely to announce details of its plan soon, namely at one of the next two FOMC meetings. On the back of the range of estimates from surveys and recently indicated by some central bank members, we can infer that Fed balance sheet could stabilize later in the year at much higher levels as a percentage of GDP vs pre-GFC percentages. In a nutshell, and despite balance sheet normalization, liquidity in the system is likely to remain abundant by historical standards, while on the composition, the Fed is likely to progressively increase the weight of US Treasuries vs MBS in its current portfolio, probably with an overall lower duration. A more dovish Fed attitude on rates normalization is therefore likely to be accompanied by "prudent and patient" balance sheet management, too. In terms of market implication, the combination of both stances should help reduce volatility spikes and perceived risks linked to the QT impact.

Risk factors

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

Risk # 1 | 20% probability | Renewed escalation in trade tensions between the US and China

Analysis | US announced to delay the tariff increase on $200bn worth of China's products, which was scheduled for 1st March. This seems to have reflected meaningful progress made in several rounds of US/China trade talks into 2019. Such talks seem to have put more focuses on core topics, including structural issues and enforcement, as well as technical details. If additional progress could achieve, another Trump/XI Summit is expected, and the probability for US/China to reach some kind of deal to avoid tariff increase and to prevent further escalation is visibly higher than in late 2018. This seems to help reduce some downside risks in the near term, and help market sentiment to have recovered somewhat. That said, uncertainty remains relatively high, and it could take much longer to ultimately solve the problems, as many complicated topics are involved. We cannot rule out a severe confrontation between the US and China yet.

Market impact | Tariffs have started to hit trade, and uncertainty have been weighing on business climate (especially in the manufacturing sector) and on the Chinese economy. Subsequently some private-investment projects have probably been postponed. Even in the absence of a large-scale trade war, global trade, which has started to slow, may thus slow down further. A chain reaction would cause a fall in global trade of goods while exacerbating local inflationary pressures in the short run (mainly in the US), putting central banks in a corner. This would cause a general rise in risk aversion (fear of a global downturn). At the end of the day, a more severe confrontation would only make losers.

Risk # 2 | 20% probability | Major European slowdown

Analysis | Eurozone GDP growth slowed down to only 0.2% QoQ in Q3, after 0.4% in Q1 and Q2 and 0.7% in Q3 and Q4 2017. While Q3 weakness was largely the result of temporary negative factors (a sharp drop in German car production due to a new emission testing regime), the growth momentum in Q4 2018 and Q1 2019 is slower than what we had anticipated a few months ago. The central scenario remains a continuation of the recovery at a slightly above-potential pace, but risks are clearly tilted to the downside, in particular in the short run (Q1 growth will likely be sluggish). Indeed, the combination of elevated uncertainty (Brexit, trade tensions) and external negative factors (notably the expected slowdown in the US) could cause growth to fall further. Lower oil prices are a supportive factor. However, a reversal of this trend would be another drag for the European economy.

Market impact | As the ECB would be left with few tools to face a slowdown, and as a coordinated fiscal stimulus would be very difficult to decide due to the complex European institutional and political environment, a major slowdown would clearly be negative for European assets and the Euro.

Risk # 3 | 20% probability | No-deal Brexit

Analysis | Faced with the threat that Parliament could vote an amendment directing the government to seek an extension of Art 50, PM Theresa May has scheduled a number of votes for mid-March. On March 12, Parliament will have another "meaningful vote" on the EU/UK Withdrawal Agreement (that was rejected by a majority of MPs in January). Should the Withdrawal Agreement be rejected again, another vote will take place on March 13 to approve or disapprove a "No-deal" Brexit. Should "No-deal" then be rejected, another vote will take place on March 14 on whether an extension of Art 50 should be requested from the EU. The market has interpreted these new decisions as reducing the probability of a "no-deal" Brexit. Yet we maintain a 20% probability for such an outcome as the next weeks will be very tense, new unexpected developments can happen and it is not completely certain (even though it is probable) that the UK and EU can agree on the details of an extension.

Market impact | We must prepare for a dense newsflow in the coming weeks. In the event that the outcome is ultimately unfavourable for the UK, we would see a weakening of the GBP and below-trend GDP growth. But should a deal be voted, the Sterling would continue to appreciate and business investment would probably benefit from a drop in uncertainty.

Risk # 4 | 15% probability | Political instability in Italy with renewed stress on sovereign spreads in the Eurozone

Analysis | The government coalition in Italy (between M5S and the League) maintained tense relations with the EU until recently. The government revised down its deficit target, with a smaller budget deterioration in 2019 (2.04% vs. 2.4%). It is not a structural adjustment, but thanks to this revision, the European Commission (EC) has decided not to launch an Excessive Deficit Procedure. The relationships with the EC have improved at least for the time being. Incoming data on contracting economic growth in Q3 and weak coincident and leading indicators for Q4 and Q1 increased the risks of another dip. With slow growth ahead (we expect GDP growth at 0.2% in 2019), tensions with the EC will inevitably resurface sooner or later.

Market impact | There is no systemic risk in our opinion. On the one hand, the rise in Italian bond yields has tightened local financial conditions and that weighs on GDP growth in Italy. But on the other hand, the absence of an EDP gave some short-term relief. Yet, the long-term outlook has not changed much. We perceive risks as remaining domestic. Keep in mind that the ECB has anti-contagion tools that it could mobilise to avoid a contagion to other peripheral markets. In addition, the ECB has “pre-announced” new TLTROs to alleviate the banking system. All of this should contain the contagion risk on peripheral sovereign spreads and on corporate credit spreads.

Risk # 5 | 15% probability | US Recession

Analysis | The US economy was stronger than expected in Q4 (+3.1% yoy), boosted in particular by business investment. However, we think that US growth will slow, in particular regarding investment after the remarkable performance seen in 2018. Consumption should remain resilient given the strength of the job market. The fact that the Fed’s normalisation is almost done (“wait and see” attitude, stabilisation of the balance sheet expected by the end of the year) will maintain very accommodative monetary conditions, which should sustain domestic demand. Against this backdrop the probability of recession remains low in the foreseeable future.

Market impact | Markets are likely to become more circumspect with regard to 2020 growth expectations as the deceleration could become more pronounced and economic signals are likely to become increasingly mixed as the cycle extends. The probability of a recession remains low. But as the cycle matures, the best choice for investors is to limit exposure to credit. . On the equity side, selection of themes, sectors and single names will be increasingly relevant.

Risk # 6 | 10% probability | Contagion in the “emerging world”

Analysis | Emerging markets suffered in 2018, impacted by (1) the Fed’s rate hikes and strong USD; (2) by the trade war rhetoric; (3) by the tightening in domestic monetary conditions; (4) by the deterioration of the outlook in several countries at the same time (Argentina, China, Turkey and South Africa). While had data continue to be below expectations in many countries at the same time in early 2019 (weak growth momentum at a global level). The fact that the Fed has made a U-turn in its communication (“wait and see” attitude on interest rates, stabilisation of its balance sheet in sight) and that the USD has peaked is clearly good news for EM markets in 2019. In addition, an escalation in the trade war between the US and China is less likely. However, should trade tensions resurface, they would push to a larger contagion (because value chains are very integrated). The market environment has turned more positive in 2019 than in 2018, and markets have rebounded since the start of the year. But the macro momentum is still weak in early 2019 and the trade-war rhetoric is here to stay, despite the de-escalation between China and the US.

Market impact | Spreads and equity markets would once again be highly hurt; it is all the more true that emerging currencies would be again under pressure with capital outflows. However, the emerging world is far from being a homogeneous block, and markets would deteriorate more in the most vulnerable countries, whether due to poor external positions whether due fragile fiscal and political conditions. Some caution about emerging markets is still required at present.

Risk # 7 | 10% probability | A Chinese “hard landing”/ a bursting of the credit bubble

Analysis | Chinese economic growth is slowing down but the authorities are working hard to stimulate the economy (monetary and fiscal policies) so that the economy is expected to remain resilient. Recent data tend to indicate that the policy mix has a noticeable positive impact on the economy. That being said, the country’s economic model is fragile: the excess of credit is visible, non-financial corporate debt has surged since the GFC. The good news is that the NFC debt to GDP ratio had started to drop since late 2017. We will continue to monitor closely the trend in Chinese private debt, especially if the economy slows. Meanwhile, the de-escalation in trade tensions should give time for China policymakers to adjust their policy implementations and to better manage short-term risks. In the case of hard landing or the bursting of the credit bubble, the Chinese authorities would be unable to avoid a stronger depreciation of the Yuan.

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

Risk # **8** | **10%** probability | **Major political crisis in Europe**

Analysis | European politics is becoming less predictable due to the rise of various non-mainstream political forces in several countries. In September, the non-mainstream Italian government coalition announced a 2019 budget in breach of European rules, thus opening an episode of tensions with the rest of the Eurozone. Although an agreement was reached, this topic could flare up again due to more fiscal slippage in 2019. In France, where the situation had been stable since the 2017 presidential election, sudden and violent social movements caught the government off guard at the end of 2018 and could complicate the continuation of its supply-side reform agenda. Although less immediately worrying, the political outlook is also uncertain in Germany (where the stability of the government coalition could be questioned) and in Spain (due to the lack of a proper majority in Parliament and the recent rise of a far-right party). More generally, the combination of strong anti-immigrant feelings and frustration towards European institutions remains a tailwind for anti-system political forces. The May 2019 European election will be a major gauge of their progress.

Market impact | Given the still positive economic backdrop, we do not believe that these events will trigger a new round of systemic crisis in Europe. Non-mainstream political forces that are in a position to rule countries (such as in Italy) have shown that they want to blame European political institutions and try to modify them, but not exit the Eurozone. However, this problematic political news flow may continue to generate market stress in 2019 while the difficulty to understand European institutions for outside investors means that European assets will continue to carry a specific political risk premium. Italian government spread vs. Bund could continue to be volatile.

MACROECONOMIC CONTEXT

Our convictions and our scenarios

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

Central scenario (75% probability): slowdown in 2019 but more decoupling looking ahead

- **Growth is slowing worldwide:** 2018 had begun based on the theme of a synchronised global recovery. But this did not last. Since the spring, the protectionist measures taken by Donald Trump have changed the game. Emerging economies, some of which are heavily indebted in dollars, have been weakened due to the broad-based appreciation of the US currency. Moreover, economic activity has markedly weakened in the Eurozone since Q4 2018. Hence 2019 has started with a global synchronised slowdown with risks remaining tilted to the downside.

- **World trade:** Global trade has surprisingly markedly weakened over the past 18 months; it started 2018 at around 5% YoY but fell sharply in Q4 (+1.4% yoy). The protectionist rhetoric has pushed up the level of uncertainty to an all-time high in December, dragging down investment. Since the start of the year, global trade remains particularly weak, with possibly another contraction in Q1. Having said that, the de-escalation on trade between China and the US bodes well and should lead to a stabilisation in trade. At the end of the day, we continue to expect global trade growth to stabilise around the level of global GDP growth (i.e. we would expect global trade to return to 3% yoy by the end of 2019).

- **United States:** The US economy has been driven by a very accommodative fiscal policy but its impact should progressively erode this year. We expect growth to decelerate to its potential by early 2020, meaning in practice that the US economy will lose 1pp of growth by the end of the year. Indeed, we expect GDP growth at 2.4% on average in 2019 and 1.8% in 2020 (yoy growth, would thus slow from 3.1% yoy in Q4 18 to 2.1% in Q4 19). This situation will have a negative impact on corporate profits, especially if some inflationary pressure materialise by then, which is still possible, given the fact that the economy is operating at close to full employment. We do believe that a recession is highly unlikely in 2019 (household consumption should continue to benefit from higher disposable income). However the doubts about the extension of this cycle are likely to rise in the coming quarters (less support from fiscal policy, business investment expected to slow). And we must keep in mind that sub-par growth may trigger a profit recession.

- **Eurozone**: We keep unchanged our forecasts at 1.2% in 2019 and 1.5% in 2020; however recent data tend to indicate that Q1 growth could still be very weak (meaning that risks to growth remain skewed to the downside in the short run). Despite a recovery that has started well after that in the US, Eurozone economies have begun to slow in 2018, much more sharply than other economies. Several transitory factors have contributed to the slowdown in EZ growth. For instance, Germany was close to fall in recession in Q4 due to an abrupt slowdown in world trade, disruptions in the auto sector caused by new pollution tests, and the weakness of the manufacturing sector. The shock on the EZ manufacturing sector at the end of 2018 has been clearly underestimated. In France, the yellow vest movement has weighed on economic activity. And the Italian economy has suffered from tighter credit conditions. In addition, political uncertainties have muddied the waters (Brexit, Italian budget). However, we stick to the view that domestic demand (in particular consumption) will remain supported by the strong labour market performance, by strong income growth and by the level of monetary policy accommodation. Subsequently, we believe that growth will gradually reaccelerate in H2. In the short term, the European elections (May 2019) and the Brexit will likely maintain the level of uncertainty at a high level. While we believe that mainstream parties will dominate the European parliament, the level of political fragmentation will increase. As a result, it will take time to form the new Commission and we do not expect any significant progress in strengthening the EU and the Eurozone before 2020.

- **United Kingdom:** The political situation in the UK is highly unstable. Many options are still possible regarding the Brexit. Everything will ultimately depend on the scenario (see section risk factors and our "investment talk" that will be soon published on the subject). We continue to believe that the probability of a deal is well above the probability of a no deal. And with a deal, we would expect a rebound in domestic demand in H2 2019.

- **China:** Chinese economic growth seems to have has stabilised in early 2019, thanks to the very expansionist policy mix, to the point that we cannot rule out a (short-lived) reacceleration of growth. That being said, the country's economic model remains fragile: the excess of credit is visible, non-financial corporate debt has surged since the GFC. The de-escalation between the US and China on trade tensions should give valuable time for China to adjust its policy implementations and to better manage short-term risks. Keep in mind however, that trade tensions between the US and China are here to stay (intellectual property, high technology).

- **Inflation:** Core inflation remains low at this stage of the cycle in advanced economies. The slowdown in inflation in recent years is primarily structural in nature, as it is tied to supply-side factors, while the cyclical component of inflation has weakened (with a flattening of the Phillips curve). Core inflation is likely to pick up only slightly in advanced economies. An "inflationary surprise" remains possible with the pick-up in wages (United States, Eurozone) but would not last long given the slowdown in global growth and the lack of pricing power (i.e. corporate margins more at risk than final sale prices). In emerging economies, inflation has recently slowed more than expected but it was mainly due to the decline in energy and food prices. At the end of the day, with low inflation and subdued growth, most central banks have turned more dovish.
- **Oil prices:** Oil prices have decreased sharply: from $86/b (Brent) in early October to $65 in late February. The main trigger at the very beginning of the decline have been the large amount of waivers conceded by the US administration to different countries with regard to the sanctions imposed to Iran oil exports. A moderate OPEC and Non-OPEC production cut decided at the beginning of December together with fear of a more pronounced economic slowdown are keeping oil prices around this level.
- **Central banks on the dovish side:** the risk management approach prevails. The Fed is in a "wait and see" mode; we expect no rate hike in the coming months (1 hike at most and not before June). The ECB has ended its monthly asset purchases at the end of December and will continue to replace maturing securities (between €160 and 200 bn in 2019). We do not expect any rate hike from the ECB in 2019 or 2020.The ECB has no room for manoeuvre to normalise its monetary policy in the short run, given the economic slowdown and the absence of inflation. In order to maintain very accommodative monetary conditions and to alleviate tensions on the banking sector, we now expect the ECB to launch new TLTROs (probably announced in March).

Downside risk scenario (20% probability): a marked trade-war-driven economic slowdown, a geopolitical crisis or a sudden repricing of risk premiums

- Risk of further protectionist measures from the US, followed by retaliation from the rest of the world.
- Repeated uncertainty shocks (global trade, Brexit, European elections) would weigh heavily on global demand.

Consequences:

- All things being equal, a trade war would drag down global trade and trigger a synchronised and durable slowdown in growth and, in the short term, inflation. That said, a global trade war would quickly become deflationary by creating a shock to global demand.
- An abrupt repricing of risk on fixed income markets, with an across-the-board rise in government or credit spreads, for both advanced and emerging economies, and a decline in market liquidity.
- Recession fear in the US.
- In the worst - albeit highly unlikely - case would once again resort to unconventional tools, such as expanding their balance sheets.

Upside risk scenario (5% probability): a pick-up in global growth in 2019

Donald Trump makes an about turn, reducing barriers to trade and engaging in bilateral negotiations with China. Domestically, the theme of increasing infrastructure spending could return to centre stage and extend the cycle in the United States.

- Acceleration driven by business investment and a rebound in global growth.
- Pro-cyclical US fiscal policy generating a greater-than-expected acceleration in domestic growth. Growth is reaccelerating in the Eurozone after a dip. Growth picks up again in China on the back of a stimulative policy mix.
- Central banks would react late, initially maintaining accommodative monetary conditions.

Consequences:

- An acceleration in global growth would boost inflation expectations, forcing central banks to consider normalising their monetary policies more rapidly.
- An increase in real key rates, particularly in the US.

Macroeconomic picture by area

United States

Risk factors

Slowing down amid policy uncertainty

- Economic growth is still above potential and consistent with a gradual slowdown, but downside risks are rising. The fiscal support that played an important role in 2018 will be fading gradually.
- Still solid labour market, wage growth and contained inflationary pressure are supporting personal consumption resilience, which is expected to be the main driver of domestic demand.
- Business confidence has moderated appreciably among small and larger businesses, while uncertainty on the growth and demand outlook may drive moderation in capex intentions and investments.
- The inflation outlook remains benign, with modest domestic and external inflationary pressures keeping both core and headline CPI in check. Lower energy prices will likely put a ceiling on the increase in annual headline inflation.
- As growth moderates and inflationary pressures remain in check, the Federal Reserve does not seem to be in a hurry to hike soon. Later in the year any hike will likely be subject to inflation trends. We expect one more hike in 2019, around mid-year.

Risk factors:

- Concerns over global growth, and external and domestic demand may hold back new capex plans
- Tariffs risk may negatively impact economic performance, both directly (prices and orders) and indirectly (confidence)
- Geopolitical risks linked to a more hawkish shift by the US administration
- Federal Reserve tightening too soon and perceived to be too hawkish

Eurozone

The recovery continues despite disappointing figures and rising political risks

- After a highly disappointing 2018, numerous indicators fell further in early 2019. However, whereas a substantial portion of this was due to export-exposed sectors (such as manufacturing), the job market weathered this well and should support consumption and services. We forecast a gradual improvement, especially from the second half of the year on.
- Brexit and the threat of US customs tariffs on vehicles are substantial risks. Major political uncertainties persist, such as the European elections and the situation in Italy.

Risk factors:

- Stronger political protest movements
- Euro appreciates
- External risks (trade war, slowdown in United States and China)

United Kingdom

Major uncertainty as Brexit approaches

- Brexit is undermining confidence and investment. After an initial rejection, on 15 January, the UK Parliament's ratification of the Brexit agreement reached with the EU in November is looking highly uncertain. Many scenarios are possible, including a postponement of Brexit beyond 29 March. While that is not the most likely outcome, a no-deal Brexit is not impossible.
- Despite political uncertainties, the job market remains strong, and wages are increasing in real terms, driven by the receding in inflation.

Risk factors:

- A no-deal Brexit
- The current account deficit remains very high

Japan

A glimpse of sour flavour in the corporate sector

- Machinery orders have recently weakened, in contrast to the resilience in 2018, amid increased global uncertainty. The accelerating global economic slowdown, especially in China and Europe, is whittling exports.
- Meanwhile steady income growth, an indispensable solution to labour shortage, is supporting domestic demand. Relatively mild weather is fostering construction.
- However, steady domestic demand is insufficient to avoid the downforce from the flagging tech sector and global auto sales, hindering inventory adjustment.
- Nevertheless, the government's infrastructure investment should ease downward pressure. The decline in imported energy prices will improve companies' terms of trade, while a sharp mark-down in mobile phone charges scheduled in April will encourage spending in other areas.

Risk factors:

- A lop-sided appreciation of the yen could threaten companies, leading to further downward revisions to capex plans

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China

- There are many near-term challenges to the economy, while there are signs that policy supports are becoming more visible.
- Exports are suffering and the property sector could soften somewhat going forward, but drag from the auto sector looks to become smaller.
- Overall credit growth showed signs of bottoming out in Q1 with strong lending figures in January.
- More policy measures are under way. Next focus is on the fiscal side, including potentially further tax cuts, larger local government special bond issuance and higher fiscal deficit, due to be announced by early March.
- US/China trade negotiations remain a key uncertainty. Recent signs have shown meaningful progress, working towards a memorandum of understanding (MOU).
- Pressures on RMB and capital outflows have eased somewhat, helped by a more dovish Fed and a softer dollar, as well as improving market sentiment.

Risk factors

- **Uncertainty in US/China trade talks**
- **Policy mistakes in managing near-term risks and the structural transition**
- **Geopolitical noise regarding North Korea**

Asia (ex JP & CH)

- The full set of GDP releases for Q4 2018 confirmed some resilience in the area, driven mainly by domestic demand, capex and household consumption. The soft external demand late last year has weakened further in early 2019 (data available as of January).
- The region's inflation figures remained very benign. Oil and food prices pushed inflation to levels lower than expected: in Malaysia January inflation came in at -0.7% YoY, with a -1.1% drag from transport (with a weighting of around 15%).
- Overall, CBs in the region are in a wait-and-see mood before shifting towards a more dovish stance, thanks to a more favourable global financial environment. India cut its policy rates by 25bps.
- India announced its Budget Law for fiscal year 2020. As expected, the government has introduced more expansionary aspects and schemes in support of rural India and consumers.

Risk factors

- **Growth outlook decelerating but still resilient**
- **Inflation still very benign, driven by oil and food prices**
- **RBI cut its policy rates by 25bps**
- **India announced an expansionary Budget Law, pausing its fiscal consolidation path**

Latam

- Still preliminary Q4-18 GDP figures confirmed better economic conditions in mid-sized and smaller countries in the region than in the largest countries. In Mexico, headline GDP is pointing lower (1.8% YoY), with a possible revision in 2019 expectations, once components are available. In Peru, Q4 GDP came in at a strong 4.8% YoY, supported too by a favourable base effect on Q417.
- On the inflation front, the overall environment remained benign. In Mexico, inflation again declined more than expected, to 4.4% YoY from 4.8%.
- The region's main central banks kept their monetary policy rates unchanged.
- In Brazil, the new president and his economic team decided to present a very bold pension reform plan to Congress. Such a brave decision will make the approval process longer and more uncertain than having opted for a more diluted version of the reform.

Risk factors

- **Better economic conditions in smaller countries**
- **Inflation is overall benign, with Mexico inflation back on the convergence path**
- **No changes in monetary policy in the region**
- **Very bold pension reform announced in Brazil**

EMEA (Europe Middle East & Africa)

Russia: real GDP growth is expected to be around 2% in 2018 and slightly lower in 2019, but growth is expected to accelerate over the medium-term, thanks to a significant infrastructure spending programme from 2019 to 2024.

- Despite the threat of potential US sanctions down the road, the macroeconomic scenario remains supportive. Russia will be among the few emerging market sovereigns with "twin surpluses" in 2019, while accumulating assets in the National Wealth Fund.
- The central bank is likely to stay on hold for the time being.

South Africa: exit from recession but no miracle

- South Africa emerged from recession in Q3, and real GDP growth is expected to be around 0.7% in 2018. For 2019, we expect a slight improvement and 1.5% growth of GDP.
- In terms of policy mix, there is very little room for manoeuvre. Due to the government's support for the national electricity company, Eskom, the fiscal outlook is worse than forecast for 2019. Inflation expectations remain high and limit the possibilities for monetary easing, even though GDP growth remains relatively weak.

Turkey: we expect double-digit inflation and a recession in 2019

- The aggressive tightening of interest rates, the rebound in the pound, the drop in oil prices and the implementation of discretionary measures on certain goods have given little respite to inflation. However, it should not fall below 20% for another several months, thus limiting the central bank's margins of manoeuvre.
- In this context, household purchasing power and corporate margins are at their lowest. We therefore expect a GDP recession for 2019 of at least 1%. The downside risks are huge and the outcome of the elections at the end of March will be decisive.

Risk factors

- **Drop in oil prices, stepped-up US sanctions and further geopolitical tensions**
- **Increased risk aversion, risk of sovereign rating downgrading, and rising social demands in the run-up to elections**
- **A too rapid easing of the central bank, a cooling of budgetary policy, and a slowdown in activity in the Eurozone**

Macro and Market forecasts

Macroeconomic forecasts
(1 March 2019)

Annual averages (%)	Real GDP growth %			Inflation (CPI, yoy, %)		
	2018	2019	2020	2018	2019	2020
US	**2.9**	**2.4**	**1.8**	**2.4**	**2.3**	**2.3**
Japan	**0.7**	**1.0**	**0.6**	**1.0**	**0.7**	**1.3**
Eurozone	**1.8**	**1.2**	**1.5**	**1.8**	**1.5**	**1.7**
Germany	1.5	1.2	1.5	2.0	1.6	1.7
France	1.5	1.3	1.5	2.1	1.5	1.7
Italy	0.8	0.2	0.8	1.1	1.2	1.5
Spain	2.5	2.0	1.8	1.7	1.6	1.9
UK	**1.4**	**1.3**	**1.6**	**2.3**	**2.0**	**2.1**
Brazil	1.1	2.0	2.3	3.7	4.0	4.5
Russia	2.3	1.5	1.7	2.9	5.0	4.0
India	7.3	6.4	6.9	4.0	3.7	4.8
Indonesia	5.2	5.3	5.3	3.2	3.2	4.0
China	6.6	6.2	6.1	2.1	2.0	2.4
Turkey	2.8	-1.0	1.5	16.2	15.8	13.0
Developed countries	**2.2**	**1.8**	**1.6**	**2.0**	**1.8**	**2.0**
Emerging countries	**4.9**	**4.5**	**4.8**	**4.1**	**3.7**	**3.8**
World	**3.8**	**3.4**	**3.5**	**3.2**	**2.9**	**3.1**

Source: Amundi Research

Key interest rate outlook

	28/02/2019	Amundi + 6m.	Consensus Q2 2019	Amundi + 12m.	Consensus Q4 2019
US	2.50	2.75	2.75	2.75	2.75
Eurozone	0	0	0	0	0.1
Japan	-0.1	-0.1	-0.1	-0.1	-0.1
UK	0.75	0.75	0.75	1.0	1.0

Long rate outlook

2Y. Bond yield

	28/02/2019	Amundi + 6m.	Forward + 6m.	Amundi + 12m.	Forward + 12m.
US	2.48	2,80/2,90	2.46	2,70/2,80	2.42
Germany	-0.54	-0,50/-0,40	-0.51	-0,50/-0,40	-0.45
Japan	-0.16	-0,20/0,00	-0.15	-0,10/0,10	-0.16
UK	0.81	0,80/1,00	0.84	0,80/1,00	0.84

10Y. Bond yield

	28/02/2019	Amundi + 6m.	Forward + 6m.	Amundi + 12m.	Forward + 12m.
US	2.66	2,90/3,00	2.69	2,80/2,90	2.71
Germany	0.14	0,25/0,45	0.20	0,25/0,45	0.26
Japan	-0.03	0,10/0,20	0.00	0,10/0,20	0.03
UK	1.26	1,30/1,50	1.34	1,40/1.60	1.40

Currency outlook

	28/02/2019	Amundi + 6m.	Consensus Q2 2019	Amundi + 12m.	Consensus Q4 2019
EUR/USD	1.14	1.16	1.16	1.20	1.20
USD/JPY	111	109	110.0	105	108.0
EUR/GBP	0.86	0.88	0.87	0.87	0.86
EUR/CHF	1.14	1.16	1.15	1.18	1.17
EUR/NOK	9.73	9.32	9.52	9.20	9.40
EUR/SEK	10.51	10.18	10.27	9.89	10.01
USD/CAD	1.32	1.30	1.31	1.29	1.29
AUD/USD	0.71	0.72	0.73	0.70	0.74
NZD/USD	0.68	0.68	0.68	0.69	0.69
USD/CNY	6.70	6.70	6.79	6.70	6.70

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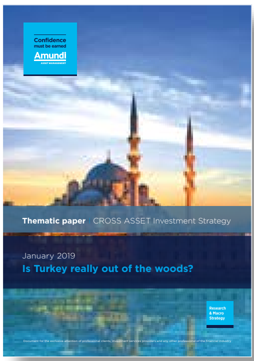

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