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Focus on fundamentals to ride turbulent markets

Investors are facing an unsettled environment. For 2019 we think it will be key to look at three areas:

1. From economic deceleration to where? It is time to look at where the economy is heading after the synchronised slowdown that the market has now priced in. A **global economic recession is not the central scenario**. The US economy is still enjoying solid growth and barring a major policy mistake (from the Fed or Trump), it should continue to grow nicely, although at a decelerating rate. Europe's slowdown is more pronounced, as it is bearing the brunt of multiple political issues (Brexit, Italy and more recently France). However, with some of the risks cooling or passing (easing of trade tensions, weaker oil prices, European elections in May), we see a possible stabilisation of economic conditions through the year, with growth expected to slow down but remain above potential in 2019/20. In EMs the picture is more varied, with some countries expected to decelerate (China) and the emergence of some positive stories (e.g., Indonesia). Overall, we still see a benign economic scenario, with trade disputes and geopolitical factors being the main risks to monitor.

2. Fed pausing or continuing rate rises? We do not share the view of some that the Fed will stay on hold from now on, even despite tightening financial conditions, as wage pressures have not disappeared and the Fed's credibility would be damaged if the market should perceive it as holding back as a result of recent political interference. On the other hand, we believe that the Fed will scale back its ambitions for tightening, as higher rates are already affecting corporate profits and financial conditions are tighter. The Fed's moves will also have consequences for other central banks (CBs); it will be more difficult for the ECB to raise rates if the Fed suspends its monetary tightening. We don't see any interest rate normalisation in the Eurozone in 2019/20. In EMs, some CBs that moved to a hawkish stance in 2018 could turn more neutral/dovish amid easing inflation conditions and less pressure on their currencies.

3. EMs: perfect storm or a recovery story? EMs have suffered multiple headwinds –higher US rates, the strong USD and idiosyncratic stories. The outlook could stabilise in H1 and improve later on amid a more dovish Fed. Our central scenario sees a soft landing in China as achievable, given the available policy space. Idiosyncratic factors (especially in Latam) and the global trade outlook will be crucial.

All in all we believe that global risk is still asymmetric as the process of repricing growth expectations and the related adjustments of risk premia unfolds, leading to a restoration of value

across the board. Still, this restoration of value and the progressive positive alignment of planets (milder path on US rates, peak in the dollar, slower US growth) bodes well for progressive exposure to EMs. Hence, we would recommend starting the year with a cautious approach on risk assets and being ready to play any opportunities that arise from the current repricing. In EMs, we suggest entering in small steps, while in DMs, as the cycle matures, the focus could move towards more **quality assets**, avoiding overcrowded/over-indebted assets and less-liquid areas of the market. In fixed income, investors should stay neutral on US duration to help mitigate overall market volatility. In credit, **the recent spread widening could re-open opportunities but with a selective approach**, as tightening financial conditions, refunding needs and the high leverage reached by many companies make this asset class vulnerable. Long-term investors should get back to fundamentals to seek valuable assets in a more volatile world.

High conviction ideas

- **Multi-asset:** We believe investors should keep limited directional exposure to equity and credit due to weaker growth momentum, geopolitical risks and fragility in investors' confidence. We maintain a focus on portfolio diversification among regional equities. EMs are attracting our attention as an end to the Fed's tightening cycle approaches and because valuations are cheap. On the bond side, we suggest exposure to US Treasuries and cautious credit exposure, with the opportunity to increase these in 2019.
- **Fixed income:** We keep a close to neutral stance on duration in the US. We see little value in rates in core Europe. We maintain a cautious approach on credit, as fundamentals remain relatively stable but spreads could remain under pressure due to rising funding needs. We continue to prefer less indebted corporate issuers. On EM bonds, we are becoming more constructive, as the market seems more resilient despite risk assets being under pressure.
- **Equities:** In the US, earnings growth is slowing due to price pressures and economic slowdown. This is a challenge for EU equities too, while we are becoming more constructive on EMs. Globally, our bias remains towards quality companies with strong balance sheets and attractive valuations given the prevailing uncertainty. In Europe "cheap" quality is now more focused on cyclicals compared with defensives, which benefited from a rally over the last three months. We think that investors should look at single stock opportunities rather than at sectors.

* EM = Emerging Markets, DM = Developed Markets, ECB=European Central Bank.

MACRO & STRATEGY



Philippe ITHURBIDE
Global Head of Research



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

“
Repricing in risk assets has gone too far, discounting a very negative scenario.
”

Central banks: Back to risk management policies

The year 2017 ended with a synchronised global recovery, with the risks of inflationary pressures likely to push CBs to normalise their monetary policy faster than expected. The possibility of a policy mistake haunted the minds of investors. This risk now seems to be behind us. First, the year 2018 ends with a risk of a synchronised global slowdown; second, core inflation has remained weaker than expected, including at the peak of the cycle in economies close to full employment. Finally, corporate financing conditions have tightened in the United States, as in Europe.

A recent study shows that an unanticipated rise in key interest rates – even a small one (25bp) – can have a significant impact on business investment, especially for young firms whose borrowing capacity depends on the value of their collateral. It is likely that this can be generalised to apply to the most indebted companies. And in the major advanced economies, it is in the US that the situation is the most worrying.

There is thus no rationale for a “monetary surprise”. In a very uncertain global environment, it is a **“risk management” approach that seems to prevail.** Inflation is not really threatening if growth slows; there is now more risk in normalising monetary policy too quickly than in keeping rates unchanged.

FED: we continue to expect two rate hikes in the first half of 2019. However, we believe that the slightest disappointment on growth would lead to a monetary pause.

ECB: the recent deterioration of the Eurozone economies and the absence of inflationary pressure prevent any normalisation of key interest rates. This is all the more true given the ECB is also seriously considering extending its long-term loan programme to the banking sector (TLTRO) to relieve the pressure on banks (especially Italian banks, which are suffering from rising sovereign bond yields).

BoE: monetary policy remains subject to the outcome of Brexit. The high level of uncertainty forces the status quo to prevail in the short run.

BoJ: there is no monetary tightening in sight, contrary to what we anticipated a few months ago. The increase in the VAT rate (on 1 October 2019) is likely to increase the risks. The governor of the BoJ recently communicated the possibility of additional flexibility if necessary, by further lowering interest rates into negative territory or even buying assets.

The lack of (significant) monetary tightening in large advanced economies in 2019 does not mean that liquidity will return in 2019. The Fed's balance sheet will continue to shrink, and that of the ECB has just stopped growing.

On the financial front, investors have thus lost the protection offered by central bank asset purchase programmes. But on the economic front, **the lack of significant tightening would help stabilise growth, which should end up reassuring these same investors.**

The Strategist's View – Short- vs long-term risk disconnection

While visibility is scarce and economic/financial conditions are fluid and uncertain, we stick to our risk assessment checklist to calibrate overall risk exposure, which remains balanced. Our risk assessment focuses on the contribution of short-term indicators (including financial conditions) and of more medium-term trackers (including risk-adjusted valuations, money velocity and total debt accumulation over growth). **Short-term indicators highlight investors' risk-off mode** being recently exacerbated by credit deterioration (HY in the energy sector) and spread widening. Financial conditions have tightened in Europe, while they are gradually deteriorating in the US. Taking into account the micro and macro fundamentals, **we confirm that the repricing of risk assets has gone too far in discounting almost recession levels.** While allowing for short-term relief, on a medium-term basis, **we detect a precarious equilibrium between growth generation (GDP)/monetary stimulus (money velocity) and fiscal stimulus (debt accumulation) at a time of rising real rates.** Hence, a more dovish Fed tone would be justified. The gap between **risk sentiment (negative)** and **fundamentals (still positive)** justifies the possibility of short-term risk assets relief, however **risk mitigation** will have to be considered for 2019. The first quarter will probably be the financial turning point after a phase of slower growth, higher rates and cumulating debt. However, a more dovish FED and the Q1 reporting season could act as a game changer, further prolonging the financial cycle.

*BOE= Bank of England, BoJ=Bank of Japan.

Moving side-lines

In the current phase, we see financial risks reflected in a series of factors, including lower liquidity, spread widening and negative earnings per share revisions. This will hurt sentiment first, before tightening financial conditions then eventually affecting the real economy. The combination of GDP growth generation, monetary stimulus and fiscal stimulus (debt accumulation) at a time of rising real rates provides for a fragile equilibrium, and we see the Fed carefully balancing the different risks. The Fed has now switched to a more data-dependent mode, and we expect risk assets to stay volatile, mirroring such a precarious equilibrium. On a longer-term perspective, we might turn selectively constructive, especially if the CBs turn structurally to a more dovish stance and reporting season confirms solid fundamentals.

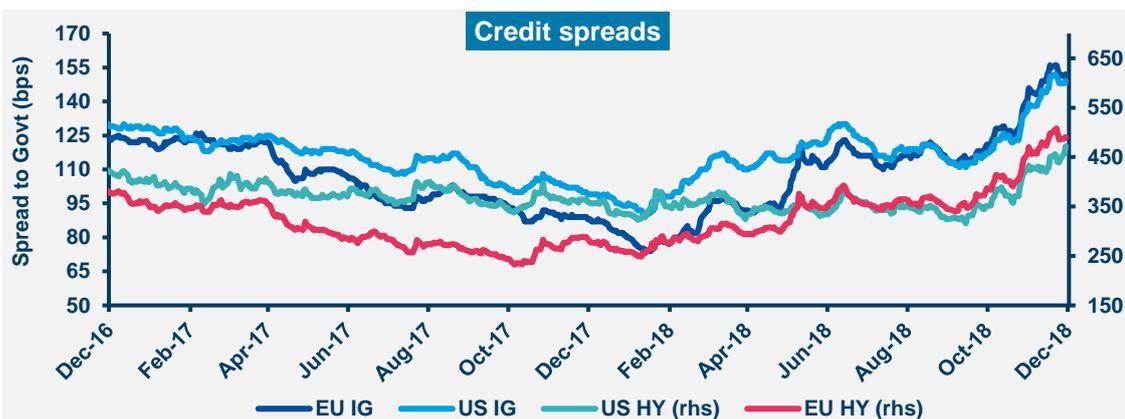
High conviction ideas

In the short term, we maintain an **overall defensive view in terms of risk allocation**, due to a mix of factors favouring a very cautious directional approach: weaker momentum in global expansion, which we expect to stay in the near term; heightened geopolitical and idiosyncratic risks, which increases the uncertainty on the policy reaction front; and fragility in investors' confidence. We believe investors should maintain a focus on portfolio diversification, favouring relative positioning for the time being in order to mitigate overall risk exposure. In November, we became more conservative on US equity among DMs, where we have a neutral view now. This was due to a deterioration in our projections in terms of growth momentum, earnings and buyback activity. In Europe, good fundamentals, reasonable valuations and a still favourable economic environment for commodities in the last race for risky assets support maintaining a tactical view on basic materials. We also keep a preference for

Eurozone value vs the overall market as a means of gaining defensive exposure, supported by valuation and technical aspects. We still favour Japanese equity, with less conviction though. The market remains cheap, with light positioning, limited exposure to geopolitical risks and resilience despite the non-exceptional earnings season. EM equities have seen a massive repricing this year, so we wonder if we are close to an entry point. Taking into account the number of challenges and vulnerabilities, we think that the policy stimulus in China will be able to support the economy, so we will gradually start approaching the market with a more directional view for the Chinese domestic sector (best represented in the HSCEI*). **On the bond side**, we have recently become more constructive on duration in the US. We also maintain a preference for US Treasuries vs German Bunds (5y bonds) and we believe investors should favour an increase in their exposure to US rates (nominal and real) if better entry levels materialise. On **credit**, we see tactical opportunities opening up in 2019 on the back of spread widening, but we keep a defensive stance in the short term as the slowing economies and deteriorating fundamentals could spur more spread widening, amid a seasonal fall in market liquidity.

Risks and hedging

Geopolitical risks and downside risks to growth are the focus. We suggest effective portfolio diversification and liquidity buffers to exploit the better entry points that will materialise in 2019. Investors should keep structural hedges to mitigate financial risks and to smooth the risk assets sell-off, with a preference for assets perceived as safe haven: gold, JPY vs USD and AUD, or options to cover widening spreads in the HY sector.



Source: Amundi, Bloomberg. Data as of 20 December 2018.

*HSCEI = Hang Seng China Enterprises Index.

MULTI-ASSET



Matteo GERMANO
Head of Multi-Asset

“
Elevated financial risks call for a still defensive stance in risk assets in the short term, while we are becoming more constructive in the medium term.

”

FIXED INCOME



Eric BRARD
Head of Fixed Income



Yerlan SYZDYKOV
Head of Emerging Markets



Kenneth J. TAUBES
CIO of US Investment Management

Cautiously seeking opportunities in credit

Overall assessment

After the sharp rise in real yields generated by Fed policy normalisation, in the last two months, US Treasuries have rallied amid political concern and economic deceleration. In a rapid move the market switched from discounting 3/4 hikes to discounting less than one interest rate hike for 2019. In this bumpy path for interest rates, corporate and EM bonds suffered strong outflows. Credit spreads have significantly repriced, discounting, in our view, a probability of recession and not just a deceleration. EMs have recently shown some resilience, possibly an early signal of investors' confidence coming back. The key question for fixed income investors, is how far the Fed can go on hiking rates, amid already tightening financial conditions. We believe we are getting close to the point at which the Fed is turning more neutral, and this would help relax some pressure on the USD and ease liquidity conditions. If our central scenario is confirmed, the Fed is likely to pause next year and there are signs of an easing in trade tensions, so we see the recent cheapening of DM credit and EM debt as an opportunity to rebuild exposure on more attractive valuations – but very gradually and on a selective basis.

DM bonds

The cyclical deceleration of the economies, combined with market uncertainties, tends to exert a downward pressure on the yield curves. We prefer US rates among DMs. In Europe, we keep a neutral stance on peripherals. In Italy, while progress has materialised, we prefer to stay prudent, maintaining a wait-and-see stance, as we expect some risk premium to remain. We see opportunities in break-even inflation, as growth is above potential and the output is quickly closing. On corporate bonds, during the second half of the year

spreads priced in the higher rates and the higher corporate leverage, creating attractive entry points on selected issuers. In Europe, new issuance could give opportunities to re-enter the market. However, Euro credit will remain volatile, as political uncertainty is high and European growth is decelerating, with risks tilted to the downside (internal and external risks, considering Europe is quite exposed to the Chinese slowdown). In the US, credit offers moderate value as fundamentals remain relatively stable, but extended credit poses some risks. We suggest to favor more liquid issues in IG and specific segments of the HY market (single-B ratings offer more opportunities of selection).

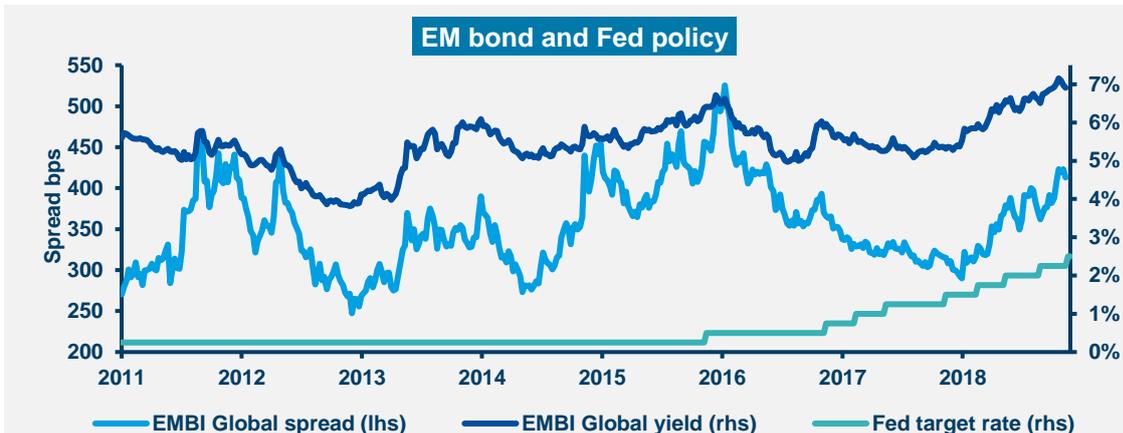
EM bonds

Sentiment has recently shifted more positive for EMs on the back of a Fed that is less hawkish than expected and a China-US trade easing. The technical backdrop is supportive for both local and external EM debt, but our preference is for hard currency at the moment, as we are confident that the asset class may deliver positive returns over the medium term (the yield on EM external debt is higher than the yield on EM local debt for the first time since 2009) while protecting investors against currency risk. We look more favourably to countries with less political risk (the political agenda is very crowded for EM in 2019), those that are less exposed to trade disputes and also those with higher carry.

FX

The upward pressure on the US Dollar should begin to wane next year. In Europe, we prefer Nordic currencies (SEK, NOK) to the Euro as these are more sheltered from Euro area political stress. The sterling could still suffer from volatility as the tail risk from the political crisis is still open.

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Some entry points are expected in EM bond, main beneficiaries of a more dovish FED in 2019.
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Source: Amundi, Bloomberg. Data as of 20 December 2018.

EQUITY

Becoming more constructive in Emerging Markets

Overall assessment

After the sell-off in October and the modest rebound in November, markets turned negative again at the beginning of December, as fears on future growth prospects dominated market sentiment. The US is now adding to the list of countries in the correction area, though a further downside without a recession is highly unlikely. A relief rally ahead is possible, with a possible trigger being a more dovish Fed. A Fed pause should also support Emerging Markets, which are already in bear territory. Hence, we are becoming more constructive on EM equity, though we do not think it is time yet to aggressively increase risk allocations as the overall economic and geopolitical outlook remains uncertain. Overall, we remain focused on quality at a reasonable price.

Europe: politics vs valuations

In Europe, additional uncertainty coming from recent yellow vest protests in France is adding to an already weak sentiment due to Brexit and Italy's budget issues. Bottom-up analysts' consensus for earnings seem elevated and revisions are likely to converge lower. European equities are discounting a bigger slowdown in growth, but certainly not a recession. Against this backdrop, we stick to the view that a strong focus on the quality of companies and the sustainability of earnings growth is key, as cost rises add pressure on European earnings. The turnaround in favour of defensives against cyclicals has been brutal – it is difficult to chase this move as valuations in defensives are trading at high levels in relative terms. We continue to see good opportunities at single stock level, but avoid big sector views. Sentiment is almost at an all-time low and the technical unwinding of positions could continue despite valuations in Europe becoming attractive.

US: time to lower the cyclical tilt

With increasing signs of economic and earnings growth deceleration, the big question is whether the cycle is over or flattening. In our view, for industries such as capital goods, banks or semiconductors, the market is waiting to see them execute successfully through a slowdown to then reward them with the positive re-rating that many of them deserve for improved, more stable business models vs prior cycles. With this observation, we have become more cautious on cyclicals, where we maintain a focus on the highest conviction cyclical stocks, those with the most valuation support that are best able to successfully navigate a slowdown. In addition, after the correction in tech, we are leaning towards increasing bias to tech and quality that can withstand late cycle pressures, while, as mentioned already, lowering our cyclical bias.

Emerging markets: improving outlook

The market is starting to price in a gentle deceleration in US growth and less hikes from the Fed – likely to lead to a weak US dollar – therefore making the environment more constructive for EM equities. We expect EMs to deliver a decent improvement in both earnings and valuations, with the valuation picture becoming increasingly attractive regardless of the different scenarios. Within EM equities, we tactically prefer China (we favour the technology and energy sectors) as most of the concerns on trade tensions seem already priced in and the Chinese policy stimulus could be enough to prevent a further slowdown in growth. Russia is attractive, in our view, thanks to the historical cheapness of equities, but it is vital to monitor the impact of sanctions. For the time being, we prefer to stay out of countries with high political risk (namely, Turkey and Argentina).

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Quality remains at the forefront in Europe and the US. EMs are reaching a floor, as a more dovish Fed could be supportive for a recovery next year.
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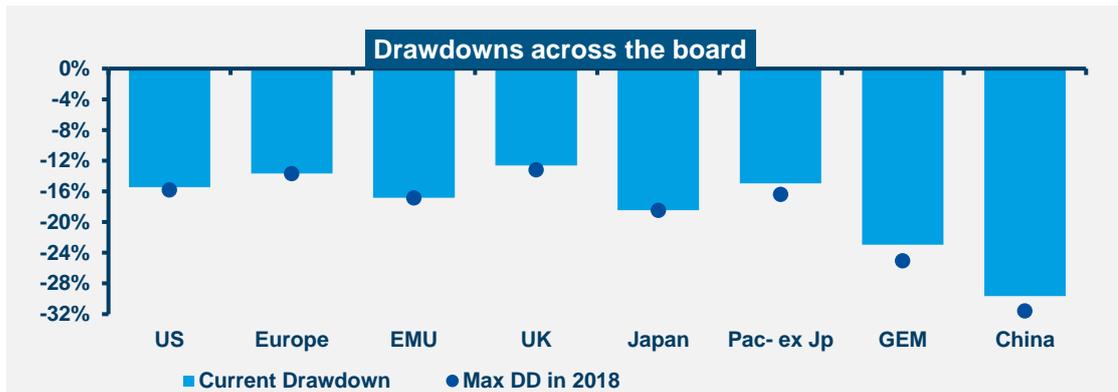
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Source: Bloomberg. As of 21 December 2018. MSCI Indexes total return in local currency. Drawdown: The peak-to-trough decline during a specific record period of an investment, fund or commodity, usually quoted as the percentage between the peak and the trough.

Amundi high conviction positions

Asset allocation: multi-class outlook								
	1 month change	---	--	-	0	+	++	+++
Equities vs govies	→				■			
Equities vs credit	↗					■		
Credit vs govies	↗				■			
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.

Relative outlook and convictions by major asset class					
	Asset class	One-month change on view	Underweight	Neutral	Overweight
GOVIES	US	↗			●
	US linkers	↗			●
	Euro core	→	●		
	Euro peripherals	→		●	
	UK	→	●		
	Japan	→	●		
CREDIT	US IG	→		●	
	Euro IG	↗		●	
	US HY	→	●		
	Euro HY	→			●
	GEM debt hard cur	→		●	
	GEM debt loc cur	→		●	
EQUITIES	US	↘		●	
	Eurozone	→		●	
	UK	→		●	
	Japan	↘			●
	Pac ex Japan	→		●	
	Global EM	↗			●

CURRENCY AND REAL ASSETS

FOREX	EUR vs USD	↗
	EUR vs GBP	→
	EUR vs JPY	→
	USD vs JPY	→
REAL ASSETS	Real estate	→
	Global infrastructure	→
	Private debt	→

LEGEND

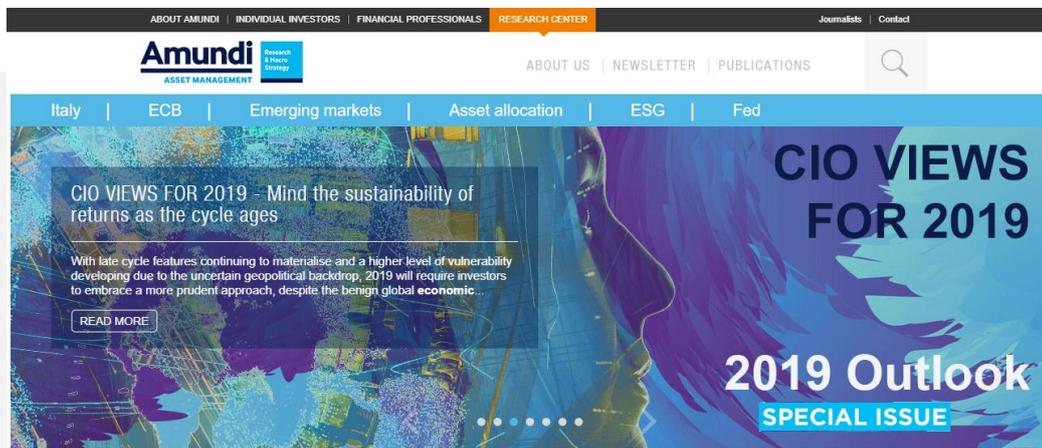
- ↘ Downgrade
- Unchanged
- ↗ Upgrade
- Underweight
- Neutral
- Overweight

Source: Amundi, as of 20 December 2018. The 3-6 month return outlook refers to research views based on expected returns by asset class. 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.**

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