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The late cycle narrative behind the autumn market malaise

The start of autumn marked a change in market dynamics. Volatility is up across the board, the US 10-year yield is flirting with its highest level over the last seven years following a rapid rise; equity markets are under pressure. After a period of highly divergent forecasts, **markets are starting to price in a synchronised slowdown** in global growth, and, hence, the fact that the peak in earnings acceleration is progressively shifting to being behind us. Some ongoing dislocations are accompanying this new situation. Cumulative hikes in interest rates in the US, while limited in absolute terms, have been sufficient to trigger the early stages of a risk-off positioning in emerging markets which have recently been negatively affected by idiosyncratic stories (Turkey, Argentina) with weak fundamentals. The risk-off sentiment has been further exacerbated by the Italian budget situation, while the most recent risk-off moves have also broadened their effects to the US in the tech area, which is very stretched in terms of valuations.

Implications related to trade disputes are also a feature of this new narrative. Protectionism is a lose/lose game: no economy will be exempted from paying its bill in the end. So far, the deterioration has been more visible in a deceleration of global trade growth and in economies with limited fiscal support, primarily in the Eurozone and China. Regarding the latter, policy actions (both fiscal and monetary) are too recent to have affected GDP growth figures. The potential impact on the US has so far been hidden behind the fiscal policy boost, but we may start to see the unintended effects of protectionism as we enter the Q3 earnings season. Possible downward earnings revisions due to tariffs, coupled with some wage pressure, could be a dangerous cocktail in a late cycle phase. If protectionism becomes structural and goes beyond being an electoral trick, it could become a risk. In our view, the impact will be more on the growth outlook and should lead central banks to lean to the accommodative side.

While this new narrative will continue to drive volatility higher, **we believe that it is premature to call it a bear market**. In our view, the configuration that is opening up has more to do with a correction than a full reversion to a bear market trend. Yet, we believe that the repricing in different assets will continue and **it is too soon to aggressively call out any obvious buying opportunity** that could emerge in areas such as **Europe**, once the

Italian uncertainty is over, and **EM**, when the threat from rising interest rates and a strong dollar potentially dissipates. We have been **scaling back overall risk for some time**, rotating towards the **more defensive spaces of quality and value** on the equity side and **adding duration** on the bond side (core government bonds -- in particular, US Treasuries). We don't see any compelling reason to change our view at this time, as we believe that interest rates in the US are reasonably close to peaking.

High conviction ideas

- **Multi-asset:** We maintain a cautious approach to risk assets in the short term, with low absolute exposure to equities and credit on the back of fragile investor confidence. In equities, we still have a mild preference for the US market and for European quality and value themes. We no longer view the UK as appealing: the potential upside for this market vs the overall European market is fading as the Brexit deadline draws closer. We remain very selective on EM assets. We maintain a low duration bias, expecting an upshift of the German curve, while we believe investors should add duration in the US. We are very selective on credit and we have recently become even more conservative on European credit. We retain hedges to protect against rising political risk and market volatility.
- **Fixed income:** We believe that bond yields could remain close to current levels. Amid rising volatility with regard to risk assets, adding duration in the US could be a defensive strategy; we still see little value in European core bond yields. In a late cycle phase, we believe investors should look to be defensive by reducing credit risk and increasing their focus on liquidity and the quality of securities.
- **Equities:** We are entering a more volatile end-of-year phase, during which market attention will be on the earnings season that is starting. This will be key to assessing the impact of tariffs, turmoil in emerging markets, rising oil prices, and a strong dollar on corporate performances. This phase calls for a rotation driven by valuations. Based on this view, we are cautious on the most expensive areas of the market (growth in the US) and we favour quality stocks trading at appealing valuations.
- **Real assets:** In a world in which the search for income has often been directed towards crowded areas of the market, we think that exploiting opportunities across the credit continuum (liquid and illiquid assets) can help to reduce concentration risk for investors with a long term horizon able to bear some liquidity constraint.

MACRO & STRATEGY



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Divergent trends ahead

We expect the deceleration of global growth to continue next year with more divergent trends both among EM and DM. Despite its length, the US cycle remains sustained. The picture is very different from the late 1990s – Asian crisis and dot.com bubble – or from the pre-GFC period in 2006-07. The non-manufacturing ISM reached an all-time high in September (series available from 1997), while the small business optimism measure (NFIB) remains close to an historical high, slightly above the levels reached in the early 1980s, under President Reagan. We thus expect GDP growth to remain strong for a few quarters. The fiscal stimulus proved to have a stronger impact than initially expected. However, given the tight job market, risks to wages are increasingly skewed to the upside. Having said that, we believe that an acceleration of wage growth would more likely put pressure on corporate margins rather than push up headline inflation. We expect the US economy to slow, but probably not before 2H19. In Europe, growth has already started to slow, especially in the manufacturing sector (due to rising oil prices, protectionist tensions, and to the slowdown in EM). But Europe continues to prove resilient and leading indicators point to above potential growth next year in the Eurozone. Political risks have, however, come back into the spotlight. In Italy, a confrontation between the Italian government and the EU Commission looks to be inevitable in the wake of the recent budget proposals by the coalition. In the

UK, we stick to our “soft Brexit” scenario, with a possible extension of the transition period beyond 2020. However, we cannot rule out an increase in tensions by the end of this year (in Italy or the UK). In Germany, a more fragmented political scenario is emerging from state elections, with the result that the coalition dominated by Angela Merkel may come apart.

None of these risks are likely to derail the ongoing recovery, but they could all negatively affect the outlook by raising the level of uncertainty. Against this backdrop, CB will continue to withdraw stimulus, but at different adjustment speeds: the Fed is reducing the balance sheet and increasing key rates; we expect one rate hike in December and two additional hikes in 1H19, then a pause. The ECB intends to wrap up its QE programme at the end of this year, and so is unlikely to make any moves on rates before September 2019. In EM, monetary policies will likely remain more hawkish than in DM, due to local inflationary pressure in many countries.

Regarding the trade war between China and the US, all eyes are now on the meeting between Donald Trump and Xi Jinping that should take place at the G20 late November (after the midterms). An escalation in trade tensions would generate further appreciation of the USD, thus weakening even EM economies further. On the other hand, a de-escalation would give these countries some breathing room.

The Strategist's View – US rates in the spotlight

Bond yields break out a temporary lift. The path should remain consistent with a late cycle phase.

The US 10Y Treasury moved higher, boosted by a recent speech by Fed Chairman Powell, a string of positive macro readings, and speculative repositioning. The move does not point to higher inflation expectations which remain structurally anchored amid a modest cyclical uptick of price dynamics. We believe that the Fed will be data dependent and will continue raising rates until a slowdown sets in rather than remaining focused on unobservable variables, such as the ‘natural’ interest rate. In line with markets, we expect one more hike in December (a total of four hikes in 2018) and two more in 1H19, unless an abrupt change in financial conditions occurs earlier. Our target for the 10Y Treasury at the end of 2018 is in a range of 3.10-3.25% and 3.10-3.20% by the end of 2019. Higher global risks could weigh on the term premium, increasing the demand for risk free US assets.

Oil vs other commodities: diverging trends. The performances of base metals and oil have been on diverging paths since this summer (oil outperformed the base metals index by more than 30%). The reasons relate more to oil, due to supply disruption concerns in Iran and Venezuela which cannot easily and quickly be offset by rises in production by other OPEC members. In fact, actual OPEC production is at the closest level to overall capacity since the end of 2007 and the oil price is usually vulnerable to the upside in such a phase, no matter the risk of demand cooling due to trade war concerns. On the other hand, base metals are benefiting less than a year ago from the cuts in production overcapacity. Recent figures confirm cuts are slowing or stabilising. This should support a recovery in base metals. On oil prices, we expect Brent to remain at \$75/bbl (equilibrium price) on a six- to 12-month horizon, assuming no supply shocks.

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We expect some deceleration in global growth, with the US remaining relatively strong.

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MULTI-ASSET

Few catalysts for a reversal in risk sentiment

Risk sentiment remains fragile, as markets are dealing with the dual worries of a late cycle economic expansion and multiple geopolitical issues. The scenario ahead remains benign, with growth above potential in 2019 in most countries. However, momentum is decelerating, with significant divergences. Among DM, the US is still expected to post a few quarters of strong growth thanks to fiscal stimulus and possible further infrastructure spending. In EM, divergences are evident among the most fragile economies in terms of external conditions and those with the strongest fundamentals. CB asynchrony is also a key theme: the main DM CB are committed to removing excessive monetary accommodation, but at different speeds and intensities, while in EM, some CB have been forced to become more hawkish to protect their currencies. Other late cycle features are the rise in oil prices and progressively tighter financial conditions. This scenario unfolds against the backdrop of an increasingly complex geopolitical environment. In Europe, investors are dealing with the Italy/EU confrontation on budgetary proposals, Brexit and, more recently, a weaker German coalition after the Bavarian elections. At a global level, risks are growing on global trade and the deteriorating US/China relationship: on the latter point, the meeting between Donald Trump and Xi Jinping at the G20 in November will be crucial. Against this backdrop, **we see few catalysts in the short term for a reversal of risk sentiment**, and thus we believe investors should adopt a **defensive strategy**, with very limited directional risk exposure and hedges.

High conviction ideas

A late cycle phase is still moderately positive for

equities that tend to outperform credit, but volatility should trend higher and it is often possible to see episodes of sudden risk repricing, as we have recently seen. In this scenario, we continue to focus on regional equity diversification, with a mild preference for the US which should be more resilient in the late phase of a cycle. We have a neutral view on Europe, where we see opportunities in the relative value space (ie, basic materials sector vs the market) and where we continue to favour quality and value on the basis of a defensive approach. In EM, we favour China vs Global EM, as we think that the policy support in China, as of now, should be able to smooth the effects of US tariffs. In **fixed income**, we remain cautious on credit and we have embraced an even more defensive approach on European credit, as political risks are resurfacing at the country level and may rise further. We also believe investors should maintain a modest short duration bias on German Bunds (where yields could bottom out) while adding duration on US Treasuries (which could act as a defensive position). Strategies that benefit from inflation surprises (ie, inflation linked bonds) could also be beneficial in a late cycle. A few words on Brexit: as the deadline approaches and with uncertainty remaining high, we have taken a more cautious view on UK equities (now neutral). We are also cautious on GBP vs Euro.

Risks and hedging

Amid geopolitical risks (trade tensions, US withdrawal from Iran deal and its implication for oil prices, evolving European political landscape), multiple hedges should remain in place to protect from equity market corrections and credit spread widening, especially in the high yield space.



Matteo GERMANO
Head of Multi-Asset

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A late cycle backdrop calls for limited directional exposure and for strategies aimed at mitigating risks.
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FIXED INCOME



Eric BRARD
Head of Fixed Income



Yerlan SYZDYKOV
Head of Emerging Markets



Kenneth J. TAUBES
CIO of US Investment Management

Defensive plays

Overall assessment

We expect that volatility will remain in place in the next weeks due to trade tensions, US midterm elections, higher oil prices, CB policy noise, and uncertainty linked to the Italian fiscal policy. We believe investors should stay defensive in fixed income. In particular, the case for a strong short duration stance is receding globally and especially in the US, where 10Y Treasury bond yields have increased, reaching seven-year highs. Hence, we think that adding some duration exposure could be beneficial in a maturing economic and financial cycle. At the same time, at this point of the cycle, as we expect tighter financial conditions ahead, investors should reduce credit risk and be extremely focused on the quality of securities and liquidity management. Divergences and fragmentation will likely persist: in DM, with strong economic data in the US vs deceleration in the rest of the world in the coming months; and in EM, given various levels of external vulnerability. This environment will remain favourable to actively playing relative value trades with a global approach.

DM government bonds

The major contributor to the rise in US yields has not been inflation (ie, that the market thinks the Fed is behind the curve), but rather real GDP growth as well as an increased term premium. Real growth estimates have risen with the recent strong numbers received on non-manufacturing ISM and non-farm payrolls. Fed Chairman Powell's somewhat more hawkish comments further spooked markets. A determined and data dependent Fed willing to avoid any economic overheating will, in our view, put upward pressure on US bond yields, but we see only temporary overshooting and limited structural upside from

current levels.. In the Eurozone, uncertainty related to the Italian budget situation is likely to continue to weigh on Italian bond risk premia and marginally also on other peripheral bonds, on which we have now moved to a 'neutral' view.

Credit

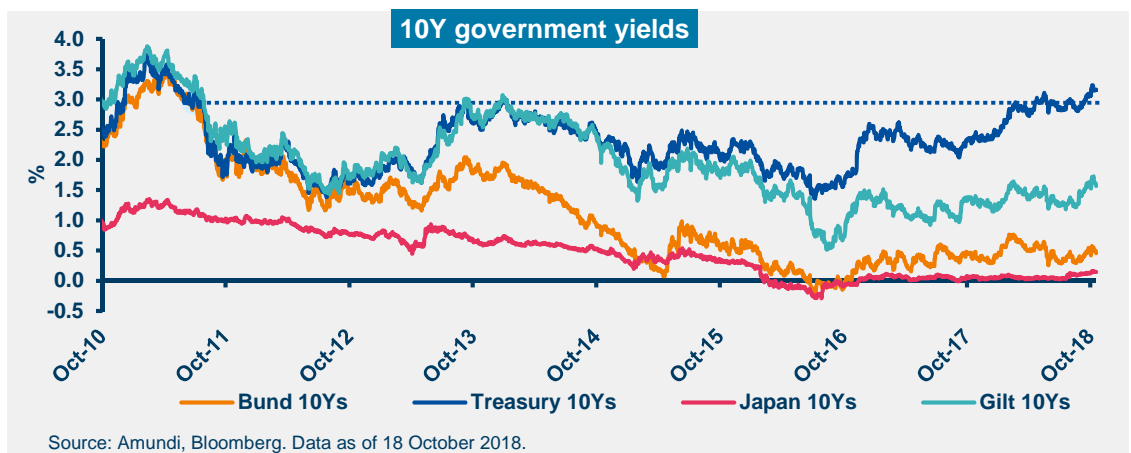
We continue to recommend a strong focus on quality in credit. In Europe, the financial sector continues to offer some opportunities, as does the subordinated space. In the US investment grade space, our preference is for banks, insurance and the energy sector. We also continue to favour loans as a source of a steady stream of returns compared to high yield bonds.

EM bonds

With a strong USD and rising US rates, EM bonds remain under pressure. We see limited room for material spread compression in the short term, after the rebound in September. As country specific stories move out of the spotlight, amid economic and policy adjustments, the asset class can offer attractive opportunities for income and carry with a long term investment horizon, but volatility is likely to remain quite elevated. In our view, selective EM dollar-denominated bonds can offer investors yield premia without exposure to exchange rate and inflation pressures. Our preference is for the energy sector, given the recent surge in oil prices, and for the GCC area* to benefit from inclusion in the main indexes.

FX

We are still positive on the USD, as global growth and rising inflation are supportive; but cautious on the GBP in the absence of agreement on Brexit and EM currencies vulnerable to a trade war.



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Risk reduction is continuing, in credit and peripheral bonds.
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ISM non-manufacturing index by the Institute of Supply Management (ISM) is an indicator of business conditions in non-manufacturing industries.

*Sovereign and quasi-sovereign debt issuers from Saudi Arabia, Qatar, the United Arab Emirates, Bahrain and Kuwait - all members of the Gulf Cooperation Council (GCC) - will become eligible for the EMBI bond index (Source: Reuters, 26 September 2018).

Focus on earnings season

Overall assessment

In the US, after a period during which equity market returns have been driven by top quintile stocks based on price/earnings (P/E) and beta, we have seen strong rotation. The top quintile P/E stocks (mainly tech) underperformed the most during the recent market selloff, while stocks with lower valuations in more defensive sectors started to outperform. We have been calling for this rotation and believe it will continue. Seeking quality stocks trading at appealing valuations will, in our view, be the way to navigate this phase of rotation and higher volatility. On a regional perspective, we think it is time to maintain a high level of diversification. Europe continues to face short-term challenges due to the Italian budget situation while EM are still vulnerable in this phase of uncertainty. Hence, we remain cautious on these areas while we recognise that they should both offer better opportunities once some risks dissipate (Italian budget and pre-midterm election tariffs rhetoric in the US).

Europe

Strong rotations occurred recently in European equities, favouring defensives and value. Yet, we think it is too early to call for a full market rotation to value, though we believe it is wise to keep a neutral sector allocation perspective and focus on a selection of companies within each sector that can deliver sustainable EPS growth and keep up with market expectations. As the cycle ages, the market becomes more tilted towards punishing companies that miss market expectations vs rewarding companies that beat estimates. This is key, especially in the banking sector which remains exposed to multiple risks, including the Italian

situation, Brexit and EM stories.

United States

Markets will be very vigilant over the current earning seasons in order to assess the impact of tariffs and a strong dollar on US corporations. Company margins are likely reaching a cyclical peak, given the progressive rise of input costs, including wages. This is usually a sign of the maturity of a cycle, but we expect earnings growth to continue in 2019 (IBES forecasts at 10%). In our view, rising interest rates and, more recently, trade issues will continue to push volatility higher. With this outlook in mind, we think that it is wise to maintain a conservative allocation and avoid over-stretched areas (most expensive growth names) that can suffer the most in what we see as a correction within an uptrend. At the sector level, we would seek opportunities in capital goods, banks and telecoms, while we are cautious on the most stretched areas of technology.

Emerging markets

EM equities remain under pressure amid fragile market sentiment. Yet, within this broad universe, we continue to see some interesting themes. One is the 'long oil' theme to take advantage of the trend of rising oil prices due to the upcoming disruption of the supply from Iran when the US embargo becomes effective in November. On this theme, we like Russia, given the low valuations and already discounted effects of US sanctions. We also see opportunities in China, especially in the technology and energy sectors. On the opposite side, we are cautious on Chile, being sensitive to the copper price, and on Turkey, due to political risk.

Signs of rotation towards value during recent selloff



Source: Amundi, Bloomberg. Data as of 16 October 2018. Chart shows the ratio between the MSCI Growth and Value indexes and the relative 3-month moving average.

EQUITY

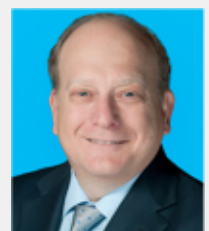
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With volatility trending higher, it is time to focus on valuations and stocks able to deliver sustainable earnings growth.
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REAL ASSETS



Pedro-Antonio ARIAS
Global Head of Real & Alternative Assets



Eric BRARD
Head of Fixed Income

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Exploiting opportunities across the credit continuum (liquid and illiquid segments) allows to seek for yields and manage interest rate risk.
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Opportunities across the credit continuum

The new fixed income landscape

With only 23% of the European government bond universe trading at yields above inflation¹, the current context of a low rate environment continues to be a key concern for European bond investors. In addition, when looking at, for example, European aggregate bond markets, not only do yields continue to be low (below 1%), but duration stands at very high levels (6.7 years)². The European fixed income market is also proving challenging as the low rate era persists at a time when uncertainty is rising as we move towards 2019, when quantitative easing from the ECB will end. At the same time political risk remains high, with confrontation regarding the Italian government's fiscal stance and EU parliamentary elections in the spotlight. Furthermore, for investors not willing to actively take currency risk, investing in USD denominated bonds may be less appealing as the cost of hedging is currently very high, making it even more relevant to seek Euro based opportunities.

Play credit continuum opportunities

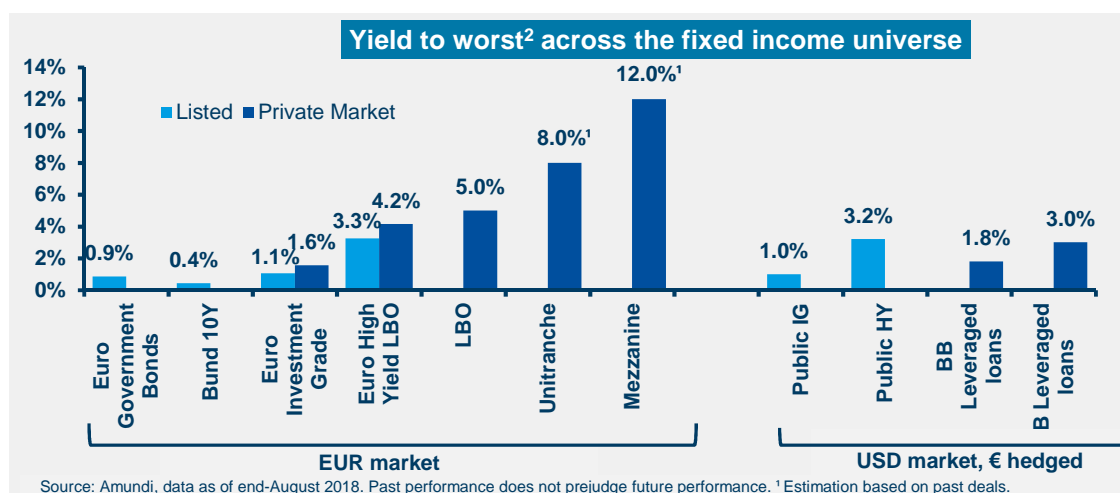
Against this backdrop, we believe that investment approaches aimed at delivering a higher yield while reducing interest rate risk can be particularly appealing for European bond investors with a long term horizon and able to bear some liquidity constraint. To seek this objective, we think it is key to look beyond the traditional fixed income paradigm and assess the European fixed income landscape as a continuum across the full spectrum of markets and segments, ranging from public to private markets, and from liquid corporate bonds (both IG and HY) to less liquid assets (including secured assets, private debt, and structured finance related debt) that can offer investors

interesting liquidity premia. In our view, such a flexible credit allocation between liquid/traditional assets with illiquid instruments allows investors to combine the best opportunities available in both markets.

For example, the inclusion of floating rate instruments may assist investors with keeping duration risk low. On an opportunistic basis, real assets (aircraft, shipping, infrastructure or real estate) can also offer different risk profiles that can help optimizing the overall allocation. With the aim of enhancing the return potential, combining listed credit and private debt assets may be helpful as well, as private debt offers a stable source of income and broadens the investment universe. In fact, while the total amount of high yield bonds outstanding is shrinking, leveraged loan issuance outpaced high yield bond issuance over the last couple of years (EUR120bn of loans issuance in 2017 vs EUR94bn in HY), providing a wider pool of investment ideas to exploit. The ability to access different instruments is also crucial to finding the best ways to execute an investment idea. For example, a senior secured loan can offer more value than a senior unsecured high yield bond issued by the same corporation thanks to a well-structured loan with protective covenants.

Focus on reducing concentration risk

We note that access to a very wide pool of assets, combined with a flexible allocation approach enables investors to hunt for higher yield with a significant level of diversification. In a world in which the search for income has often been directed to crowded areas of the market, we think this new approach can offer both higher flexibility, value and reduced concentration risk.



1 Source: Amundi analysis on Bloomberg. Data as at 17 October 2018. Based on the constituents of the ICE BofAML Euro Government Index. 2 Source: Amundi analysis on Bloomberg. Data as at 12 October 2018. Data refers to Bloomberg Barclays Euro Aggregate Index. Quantitative easing (QE) is a type of monetary policy used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.

2 Yield to worst: The lowest potential yield that can be received on a bond without the issuer actually defaulting

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	1 month change on view	Underweight	Neutral	Overweight
GOVIES	US	↗		●	
	Euro core	→	●		
	Euro peripherals	↘		●	
	UK	→	●		
	Japan	→	●		
CREDIT	US IG	→		●	
	Euro IG	→			●
	US HY	→	●		
	Euro HY	→			●
	GEM debt hard curr	→		●	
	GEM debt loc curr	→		●	
EQUITIES	US	→			●
	Eurozone	→		●	
	UK	↘		●	
	Japan	→		●	
	Pac ex Japan	→		●	
	Global EM	→		●	
	Convertibles	→			●

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 18 October 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.**

AMUNDI Investment Insights Unit

The Amundi Investment Insights Unit (AIU) aims to transform our CIO expertise, and Amundi's overall investment knowledge, into actionable insights and tools tailored around investor needs.

In a world in which investors are exposed to information from multiple sources, we aim to become the partner of choice for the provision of regular, clear, timely, engaging and relevant insights that can help our clients make informed investment decisions.

INSIGHTS UNIT



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Investment Insights
Unit



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Insights Unit

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