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May 2019 # 05

Confidence must be earned

Amundi ASSET MANAGEMENT

# CROSS ASSET

## INVESTMENT STRATEGY

## CIO VIEWS

STILL SOME JUICE LEFT BUT NOT MUCH

## THIS MONTH'S TOPIC

EUROPEAN EQUITIES: WHAT IMPACTS IN THE EVENT OF A TARIFF WAR WITH THE UNITED STATES?

Research & Macro Strategy

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

# CIO VIEWS

## Still some juice left, but not much

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

Equity markets have remained buoyant in recent weeks: the S&P 500 is trending towards an all-time high, the European equity market (STOXX 600) is close to last year's peak and the performances of emerging markets have also been very strong. Renewed hopes of a trade deal between China and the US drove the last leg of the upside, following the previous boost from the recent central banks' dovish turns. Credit markets have also been significant beneficiaries of the positive sentiment, with spreads tightening massively in Europe and stable at tight levels in the US in recent weeks.

Market complacency seems to be the name of the game in an environment of strong financial markets amid weak real economic performance. To explain this, we should note that the global risk asset rally has essentially been driven by a single factor: inflation. The downward adjustment of inflation expectations has driven yield curves lower across the board and steered developed market and emerging market central bank policies towards dovish territory. Central banks have successfully recreated the 'Goldilocks' environment, which boosted risk asset returns in 2012-2017.

The question is, where will we go from here? Is the low interest rate force strong enough at this point of the cycle and at current market valuations to push the rally further? While there is little probability of seeing a reversal on this front – the low interest rate environment looks to be here to stay – **we believe market sensitivity to the growth factor will increase in a late cycle phase**, with a clear focus on recession risk and earnings sustainability. Consensus expectations are for double-digit earnings growth in 2020 for the S&P 500, which is an optimistic view, in our opinion. To us, the risk of disappointment looks to be significant. This means that investors should aim to enhance diversification, stay defensive and seek opportunities that could emerge in case of positive market evolution.

In the short term, three factors point to an extension of the rally: easier financial conditions, the favourable relative valuations of equities vs. bonds (the differential between the earnings yield and the 10Y government bond yield is attractive compared with historical averages since 1987), and the fact there is still some potential for price/earnings ratio expansion. Further relaxation of trade concerns, based on signs of a US-China deal possibly approaching and macro figures catching up, with the increased fiscal spending possibly passing through real activity, should support movement in this positive direction.

Therefore, **we believe that while there is still some juice left, it's not that significant, especially as markets are already pricing in some perfection**.

Looking beyond the short term, the picture is rather blurry. The probability of negative returns will increase, in particular stemming from the combination of two elements. The first is that market valuations are not particularly compelling. According to our forecasts, the Shiller cyclically adjusted price-to-earnings (CAPE)[1] ratio, a measure of market valuation, should drift to about 28 at the end of 2019, from the current level of 31. This projection, even if lower than the level reached at the beginning of 2018 (33), is close to 1929 figures and historically expensive. The second element is that looking at history, a material downward earnings revision (i.e., one driven by an economic recession), combined with expensive valuations, is negative for equity markets. Hence, the earnings outlook is becoming the key factor in whether or not the market continues its positive uptrend.

*In balancing the short-term upside potential with these downside medium-term risks, our overall approach has been (and should continue to be) to trim the total risk in portfolios, take profits on strength and reallocate on setbacks to areas where we still see value to exploit in relative terms. In this regard, emerging markets, European equity and some segments of the credit market are the natural candidates.*

[1] *Cyclically adjusted price/to-earnings (CAPE) ratio, otherwise known as the Shiller PE after Robert Shiller, who popularised it, measures the price of a company's stock relative to average earnings over the past 10 years.*

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

## Overall risk sentiment

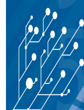
Risk off Risk on

We keep our previous cautious stance, waiting for further visibility from the earnings season.

## Changes vs previous month

- More positive on EM equities vs. DM
- More cautious on US credit and on US duration
- Limited upside for EM LC debt

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



# MACRO

## Multi-speed global growth

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

**Relaxed financial conditions: a supportive factor for domestic demand.** Since the beginning of the year, monetary and financial conditions have eased, thanks to falling interest rates and credit spreads, along with rising stock markets. This is what led us to revise upwards our GDP growth forecast in the US from 1.8% to 2.0% in 2020. This supportive factor is expected to last as the major CBs have promised implicitly to maintain very accommodative monetary policies. **Stabilising global trade**. An agreement between the US and China is expected. Donald Trump, however, has threatened to tax imports of certain products from Europe (aeronautics in particular), which shows that the protectionist risk has not disappeared yet. The US President has, however, refrained from threatening the European automotive sector, which may mean that he does not have the domestic support needed to move in this direction. We note that uncertainty indices fell in most advanced economies in March, including in the US, with respect to trade-related uncertainty, which bodes well for trade.

**Surveys (PMI): first signs of stabilisation (or even recovery) in March**. More than half of the purchasing manager indices have improved, especially in new orders. The movement is still tentative but tends to confirm that the cycle trough has passed. The improvement is clear in the US and China, but not in Europe where the manufacturing sector is particularly weak.

> “After weak global economic data in Q1, some signs of stabilisation seem to be emerging.”

However, there are signs that Eurozone economies will recover: PMI services, household confidence, industrial production, retail sales and car registrations are on the rise. Given the degree of integration of global value chains, it is expected that the global recovery will gradually spread to Europe. Domestic demand is supported by rising incomes, job creation and an expansionary fiscal policy, which is estimated to support growth in 2019 by 0.2%. Italy remains the weakest link in the Eurozone, where it is even possible that GDP contracted in Q1 for the third consecutive time. Public debt will not be sustainable in the long term without a rebound in growth. Short-term risks are nevertheless very limited given the accommodative fiscal policy and the hitherto rather conciliatory attitude of the European Commission ahead of the European elections.

**The risks on growth remain tilted to the downside**. On the one hand, the threat of a ’no deal Brexit’ is receding with the postponement to the end of October of the deadline, while China and the US are managing their trade disputes through negotiation. But we cannot definitively exclude a tougher confrontation between the US and China or between the US and Europe on trade, particularly in a context where the EU is weakened both economically and politically. Moreover, Trump’s repeated threats to the Fed’s independence are starting to seriously worry CBs around the world.

# The Strategist's view

## US govies overreacted to a dovish Fed

The dot plot chart* published at the last Federal Open Market Committee meeting has erased both of the 2019 hikes indicated in December: this move was more dovish than expected, as it was the downward revision to long-term forward guidance below the neutral rate. The end of quantitative tightening (QT) was widely pre-communicated, but the timing of the announced stop was earlier than expected. The Fed's balance sheet will stabilise at about 17% of GDP, significantly higher than pre-great financial crisis (GFC) levels. Starting in October, maturing mortgage-backed securities will gradually be reinvested in US Treasuries, but with lower maturities. Finally, the Fed also marked down near-term growth projections to the outlook, confirming at the same time a reassuring picture for the next two years. Taken by surprise, bond markets likely overreacted, initially pricing in a rate cut in September, and then slightly repricing to a less dovish expectation (a rate cut between October and December 2019) on the back of softer macro numbers from China, the US and the Eurozone.

The 2-10 yr Treasury yield differential signals that downturn expectations are growing, but we are convinced that the curve's predictive power on the cycle has probably been reduced by special factors at work in the post-GFC regime, such as QE's persisting effects.

In this environment, we keep our preference for US Treasuries among developed government bonds, as we have lowered our expected US 10 yield targets in six months (2.5%-2.7%) and one year (2.4%-2.6%), with this reduction being more material than for other markets. However, we believe that better entry points to increase duration in US Treasuries will materialise in the coming weeks, as Treasuries probably overreacted to the Fed surprise and are already somewhat correcting

** Fed dot plot chart is a representation of how the Fed's members see the evolution of interest rates in the next few years. The neutral (or natural) rate of interest is the rate at which real GDP is growing at its trend rate, and inflation is stable.*

*QE: 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. QT: Quantitative tightening is the opposite of quantitative easing.*

MULTI-ASSET

# Remain defensive, but watch for positive surprises

MATTEO GERMANO, Head of Multi-Asset

We maintain a **cautious approach** as the strong market rally now appears to lack supporting factors, particularly in DM equities. Improving dynamics on the earnings side, or positive surprises in lacklustre European growth could justify a more positive stance on equities, but at the moment visibility is limited and the **geopolitical situation does not encourage an aggressive stance**. In Europe, the ongoing Brexit saga, the European Parliament elections and surging populism are putting the entire EU institutional architecture under scrutiny. The changing nature of various trade disputes (with the relationships between US-China and US-Europe fluctuating depending on the newsflows) also add further uncertainty. However, we recognise that some of these risks could become opportunities in the event of positive surprises on the geopolitical side (for example Brexit, or US-China trade negotiations), that could trigger further upside in the market.

## High conviction ideas

**Risk assets' performance** has been significant so far in 2019, and as a result undervaluation gaps have closed almost entirely after the strong rebound from December 2018's falls.

As a result, we maintain our **short-term cautious stance on DM equities** as euphoria could wane, but we are also looking for opportunities to benefit in case of potential positive surprises. In **Europe,** for example**, call options on UK stocks** could prove attractive in the event of a potential resolution of Brexit and come at a low cost given the current depressed levels of volatility.

We also favour **EM equities**, **(**particularly China, which is supported by recent policy stimulus, suggesting a more gradual slowdown and supportive risk sentiment). Korea is also an area of interest to us. The market is seeing some improvement in fundamental (exports, consumer sentiment) and **Korean stocks** should also benefit from positive developments on the trade front and from a short-term mild recovery in the global economic cycle.

**In credit markets our preference is for the European investment grade space**, where fundamentals are positive (no excess leverage, and no specific refunding issues), valuations are still decent and the expected TLTRO could support the asset class in the medium term.

**On rates**, we believe valuations are extremely expensive in Europe. Hence we maintain our preference for US Treasury versus German Bunds, and we plan to adopt a more aggressive stance on duration should US yields back up to more appealing levels. We are negative on UK long-end real yields.

> "Within a defensive approach, it is time to seek opportunities that could emerge in case of the positive evolution on current areas of uncertainty (Brexit, trade)."

**On currencies,** the outlook for the USD remains bearish in the medium term given its overvaluation. However, for the Euro to rebound materially, an improving global trade outlook is necessary. Short term, we are positive on the Norwegian Krone (NOK) on the back of tightening monetary policy. We also see opportunities in EM currencies, preferring these with positive carry (Indonesia, Russia, Brazil) against higher risk currencies (South African Rand).

## Risks and hedging

Key risks to monitor are: political tensions over trade disputes (US-China, US-Eurozone), the Eurozone's heightened political uncertainty and the effectiveness of policy mix in China to avoid hard landing. As a hedging strategy, we maintain a positive view on the Japanese Yen vs. USD (the Yen should behave as a safe heaven in the event of a negative surprise on the trade front). Some structural hedges through options are also recommended in this regime of low volatility.

| Amundi Cross Asset Convictions | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | 1 month change | --- | -- | - | 0 | + | ++ | +++ |
| Equities | | | | □ | | | | |
| 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

## Time to be flexible, amid higher uncertainty ahead

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

The backdrop for fixed income is one of global economic slowdown (with some reacceleration in Europe and in EM) and subdued inflation pressures. Central banks (CBs) confirmed their dovish stance and the Fed has put on hold the normalisation of its monetary policy, leading markets to almost discount a cut before year-end. The ECB confirmed its dovish stance, going further than previously anticipated by the market. Yet, should the economy deliver above expectations, uncertainty on CB actions will return. Hence, **we don't see a case for particularly aggressive positions on duration**, while we continue to view the environment as favourable for carry, with modest scope for further tightening of credit spreads after the movements seen since the beginning of the year.

> "It is not time to be aggressive on duration, as the market may be overpricing a possible rate cut from the Fed."

### DM bonds

**With a global perspective**, we stick to three main convictions on government bonds: 1) There is no value in European core government bond yields at zero/negative level; 2) We have a more positive view on duration in peripheral bonds and we maintain a preference for the US to Germany; and 3) In Europe we expect the curve to flatten on the 5-30 years segment.

**In the US**, we think that uncertainty about the Fed's policy path may soon return as economic growth could prove more resilient than expected. The market could be overpricing a possible rate cut and as a result, we prefer a defensive stance on the US curve, especially in the 10-year space.

### Credit

**In Europe** the search for yield remains a key theme; we think there is still room for some further spread tightening on the back of a supportive ECB. Here, we prefer **short-term maturities and higher yielding bonds**. We continue to see opportunities in financials (subordinated space).

**In the US,** as spreads have almost fully retraced their fourth quarter widening, we are becoming more cautious. **As an alternative to credit, we prefer non-agency securitised sectors**. These assets are less exposed to global risks, they benefit from a positive backdrop in relation to US consumers (rising incomes and low indebtedness relative to income) and they generally offer attractive valuations relative to their risk.

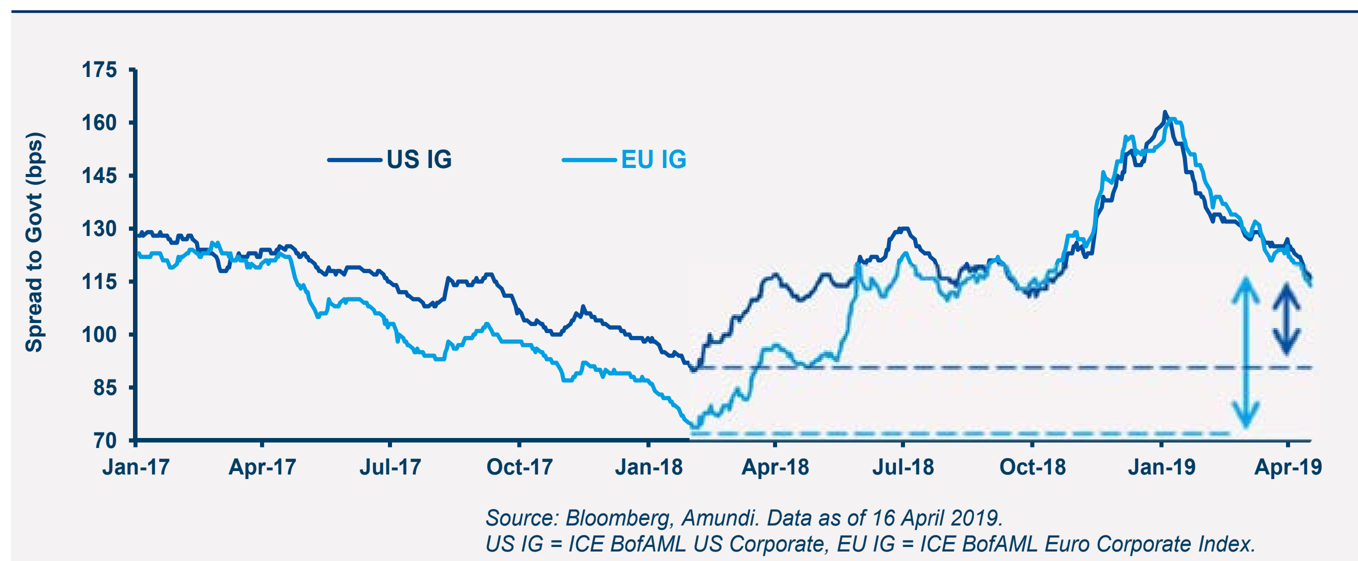
### EM bonds

Given the sharp rally since the beginning of the year, most of the returns might be behind us and we may be adopting a more cautious stance from now on. Nonetheless, the continued dovish stance by the world's major central banks and an expected further easing in trade tensions may still play in favour of EM debt markets, setting the tone for another bit of upside in the next months. We thus remain moderately positive on EM debt, with a tilt towards hard currency (especially in some high-yielding countries) over local currency, wherein we prefer to be very defensive at this stage, on recent sluggish risk-adjusted returns, and wait for stronger signs of global growth stabilisation before re-engaging.

### FX

In the short term, we stay positive on the USD, as with high yielding currency within DM; in the medium term we are neutral on the British Pound and on Japanese Yen, even if the policy normalisation could trigger some appreciation of the latter currency. On EM currencies, we suggest a cautious stance, but are watching growth dynamics as key triggers for a more constructive view moving ahead.

**IG credit: Preference for Europe**




*Source: Bloomberg, Amundi. Data as of 16 April 2019.*
*US IG = ICE BofAML US Corporate, EU IG = ICE BofAML Euro Corporate Index.*

## EQUITY

# Bull market to be tested by the earnings season

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

### Overall assessment

While March 2019 marked the 10-year anniversary of the bull market for the S&P 500 after its bottom during the great financial crisis, April saw the market lift back to the 2018 highs, while measures of expected volatility both in the US and Europe are back to very low levels. Lower inflation expectations driving the dovish turn in central banks' stance have been the key driver of the year–to-date moves. As we enter the earnings season, **the market's focus is now switching to assessing the outlook for corporate earnings for the second part of the year and for 2020,** and as a result we expect some short-term consolidation. Factors that could further


Amundi
ASSET MANAGEMENT

drive a prolongation of the bull phase are: the Fed's ability to successfully manage the slowdown in the US, a weaker USD and some upturn in the Chinese and European economy in the second half of the year, which could help global growth stabilise. While waiting for the earnings season to confirm this outlook, less supportive valuations call for a cautious approach to equities and a preference for EM given the wider growth differential ahead with DM, the support of the Chinese stimulus and the improvements on the tariffs front.

## DM equities

**In the US market,** the market focus is on companies' forward earnings guidance. A stronger outlook on top-line growth, along with still-manageable wage inflation, would suggest that the trajectory of profit margins is likely to reverse quickly. Yet, as the economic outlook and Fed policy remain areas of uncertainty, we expect a possible rise in volatility and markets to become more selective. The upside could continue, but will likely not affect the overall market. In this phase we focus on avoiding the overvalued areas of consumer staples and utilities, while exploring tech growth opportunities.

**In Europe,** valuations have reset after the rally and are now in line with historical averages. Yet positioning in Europe is very light, and could improve in case of further earnings delivery and/or the resolution of political risks. Our preference is for cyclicals vs. the defensive sector and for industrials within the cyclical space.

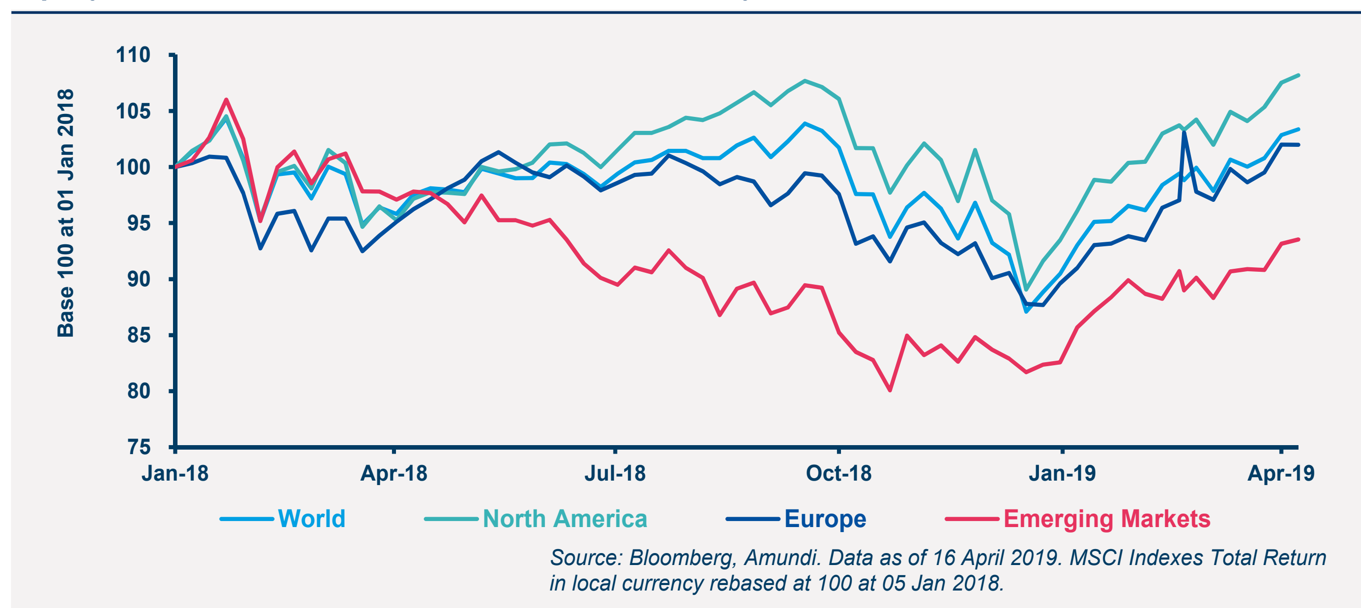
We recommend **a neutral to cautious approach in Japan,** being aware that more attractive valuations come at the risk of a strengthening Yen in case of possible volatility bouts linked to negative surprises on the tariff front.

> "The earnings outlook will be key to assessing further upside in the market. We favour emerging markets with more appealing valuations."

## EM equities

The macro and fundamental backdrop remains reasonably supportive for EM equities. In addition, the trade tensions relief and the more dovish central banks' tone have helped to foster risk sentiment. **EM equities valuations also look relatively attractive** vs. DM equities. We remain broadly **positive on China** in the expectation of a proper trade deal with the US, which is not yet fully priced in, and Chinese stimulus measures that have yet to kick in completely. We are also moderately positive on Russia given attractive valuations. More uncertainty is instead rising on the European side, which is becoming the new front of the US trade confrontation.

**Equity Markets Performances: Still room of recovery for EM**




*Source: Bloomberg, Amundi. Data as of 16 April 2019. MSCI Indexes Total Return in local currency rebased at 100 at 05 Jan 2018.*

## Amundi asset class views

| | Asset Class | View | 1M change | Rationale |
|---|---|---|---|---|
| EQUITIES | US | -/= | | We expect some volatility in the market in the coming weeks. The recent favourable movement has been due to good news from central banks and China-US trade talks, which stimulated risk appetite. Some early signals of the earnings season seem positive, showing that revisions are starting to improve again. Further confirmation is needed to see a continuation of the bull market. |
| | Europe | = | | Earnings delivery and/or the resolution of political risks is needed for further upside. Stabilisation of economic indicators, in Europe but also in China/Asia, could provide a catalyst for further upside in the coming months. |
| | Japan | -/= | | The earnings per share momentum is weak, although valuations are attractive. In the last few weeks we have become more cautious on Japanese equities, try to find some bottom-up opportunities. |
| | Emerging markets | ++ | ▲ | Earnings revisions further improved in March in Asia and showed some stabilisation in EMEA. If the cycle is to be prolonged, EM should benefit most from Chinese stimulation, a weak USD and the finalisation of the US-China trade agreement |
| FIXED INCOME | US govies | = | ▼ | The market is expecting a very dovish Fed and is starting to discount even an interest rate cut. This exposes the government bond market to some risk of upward pressure on yields, in case of stabilisation and an improvement of the global economy in H2. |
| | US IG Corporate | = | ▼ | Valuations have become tighter, and there is little room left in the short term for further spread compression. Within corporates, we favour sectors less vulnerable to event risk and economic downturn exposure. We prefer to look at opportunities in securitised markets |
| | US HY Corporate | = | | Our outlook for the asset class is broadly unchanged. We see valuable carry, but limited space for spread compression at the current level. The still sound economic picture is benign for the default outlook. Default rates are expected to remain very low in 2019. |
| | European govies | -/= | | Bund yields are very low, and exposed to some risks of modest increase should the EU economy mildly rebound in H2, as we believe it will. Pockets of value can be found playing yield curve flattening and Euro peripheral bonds. |
| | Euro IG Corporate | + | | Valuations have become less compelling after the aggressive spread tightening but the asset class is still attractive for carry reasons. Subordinated debt is an area of interest on this respect |
| | Euro HY Corporate | + | | Leverage is still low and default rates are likely to stay low in the next 12 months. In a scenario of stabilising growth in the Eurozone, the asset class could provide attractive carry opportunities. |
| | EM Bonds HC | =/+ | | Our view is still constructive on HC debt, as financial conditions are supportive at the global level and the risks of a Chinese hard landing are receding. We still see room for some upside. |
| | EM Bonds LC | =/+ | ▼ | We have become more cautious on the asset class in recent weeks, after the positive price action that reflects most of the expected good news. The asset class is still attractive for carry, while the overall spread tightening from current levels is limited in the short term. |
| OTHER | Commodities | | | Geopolitical tensions in the Middle East, Iran sanctions and the Venezuela political situation, in our view, will inflate volatility and will exacerbate supply disruption concerns. Recent events in Libya may offset entirely the overall picture related to shale oil production in US, which is expected to lift further in the next quarters. Our forecast is for WTI is in the 55-65 range year-end. Base metals will be affected by the global economic slowdown. The picture remains supportive for delivering decent returns as the inventories cycle remains reasonably supportive. |
| | Currencies | | | We still expect the USD to be exposed to downside risks throughout the year, although it could remain supported in the short term as markets are questioning global growth prospects and political uncertainty (mostly related to Brexit) weighs on risk sentiment. Our target for the EUR/USD is 1.17, for the USD/JPY 107 and for the EUR/GBP 0.86 in 12 months. |

**LEGEND**

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Negative Neutral Positive Downgrade vs previous month Upgraded vs previous month

Source: Amundi, as of 19 April 2019, views relative to a Eur-based investor. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research, investment advice or a recommendation regarding any fund or any security in particular. This information is strictly for illustrative and educational purposes and is subject to change. This information does not represent the actual current, past or future asset allocation or portfolio of any Amundi product. / IG = Investment grade corporate bonds, HY = High Yield Corporate; EM Bonds HC / LC =EM bonds hard currency / local currency. WTI= West Texas Intermediate.

# THIS MONTH'S TOPIC

## European equities: what impacts in the event of a tariff war with the United States?

IBRA WANE, Equity Strategy

Finalised on 25/04/2019

### The essential

While the threat of a large-scale Sino-US tariff war appears to be receding, the US could now switch its focus to its trade deficits with the European Union. With this in mind, we wanted to find out which European equities, in terms of country, sector or individual companies, would be hardest hit by a trade conflict. A review of the indice showed that 20% of aggregate sales of MSCI Europe companies were to the US, vs. 14% for the MSCI US in the other direction. In the event of a conflict, the US would therefore be less exposed, but both sides would definitely lose out. And while the European Automobiles & Components are generally singled out, other sectors such as Capital Goods, Food, Beverages & Tobacco or Healthcare which are even more exposed to the US could therefore prove at risk.

### A possible lull in the Sino-US conflict

**While growth in international trade volumes plunged last year**[1], driven down in particular by the Chinese economic slowdown and protectionist US rhetoric, the **markets are now keeping a nervous eye** on initial signs of a **take-off in China** and headway on Sino-US **tariff negotiations**.

**On both fronts, a lull appears to have been forming in recent weeks** in the rebound in PMI and retail sales figures in China, and in recent high-level Sino-US meetings. However, **some caution is in order**, as 2019-2020 growth targets for Chinese GDP are barely over 6%, and as there appear to be some ulterior motives in tariff negotiations between the two superpowers. Even so, this lull, combined to the soothing language from central banks, has played a clear part in the market rally so far this year.

### Out of the frying pan, into the fire

**For an investor in European equities, however, it would be premature to consider that most trade risks have been resolved, given US tariff temptations and Brexit uncertainties.**

With an improvement now looming on the Sino-US front, **the US** may now shift its gaze to its bilateral deficits with **the European Union** (EU). Following Donald Trump's scathing words regarding the BMW and Mercedes crowding Fifth Avenue and the raising of customs tariffs on European steel and aluminium, the Commission president, **Jean-Claude Juncker, met with Trump last July** and a **truce** was then concluded, pending further negotiations. Meanwhile, the US commerce secretary raised the bar in mid-February, presenting Trump with a report suggesting that **imported cars** "threatened national security"; this gave the president 90 days, i.e., until mid-May, to make a decision. And in early April, the US also raised again the issue of public subsidies to **Airbus**. On the other side of the Atlantic, on 15 April the European Commission got a green light from the EU Council of Ministers to negotiate a **new trade agreement with the US**. The EU trade commissioner, Cecile Malmström, will be in charge of negotiations with the US trade representative, Robert Lighthizer. Talks will deal solely with manufacturing tariffs, to the exclusion of agriculture, services, access to public procurement and protection of investments.

[1] *Falling from +5.0% in the first quarter of 2018 to 1.4% in the fourth quarter on a year-on-year basis.*

Meanwhile, after three years of foot-dragging, a **no-deal Brexit** could automatically trigger customs duties as provided under WTO rules. The duties would vary from one product to the next and would amount, for example, to 10% in Automobiles & Components.

Both the UK and continental Europe would take a big hit, as the UK exports 631,000 vehicles annually to the 27 other EU countries (81.5% of UK output is exported, of which 51% to the EU), and the EU almost 1.8 million vehicles to the UK (12% of their total production and 32% of their exports). As the average price of a new vehicle in Europe, excluding VAT is about €25,000, WTO customs duties would raise their cost by 10%, or €2500. As cars have a high price elasticity of demand, this could result in a 10% decline in sales of the models involved.[2]

## Who would be hit the hardest?

In the event of a tariff war, who would be hit the hardest? On a macroeconomic level, various national and international bodies have already provided some useful indications.

According to the **European Commission**, for example, although the bilateral trade relationship, strictly speaking, is structurally in the EU's favour, a broader view, including services, investments and repatriated profits, shows far greater balance, with a slight surplus in the US's favour in both 2017 and the past decade (2007-2017)[3]. Meanwhile, the **Bank of England** has estimated that a global trade war – in which the entire world raised tariffs by about 10 percentage points – would subtract about 2.5% from global GDP growth over three years. Looking at Brexit alone, in a report last November, the **UK government**[4] estimated that, in the event of a no-deal Brexit, UK GDP could decline by 8% in the long term (i.e., about 15 years) compared to its initial trajectory. According to various forecasters, the UK could hover around recession territory in 2020, rather than achieving the 1.4% currently forecast. Last but not least, in a recent article of the **ECB Economic Bulletin** on "the economic implications of rising protectionism, a euro area and global perspective"[5] the authors estimated that "*the impact so far were expected to remain contained, however, large negative effects could materialise if trade tensions were to escalate further*".

Our approach focused on equity markets is less academic and more practical. Our concern is, above all, to distinguish which countries, sectors or individual companies in Europe would be the most exposed if customs tariffs were to be raised. To do so, we listed the geographical exposure of various indices and sub-indices concerned. This filter is, of course, oversimplified. To make it complete, we would have to include not just sales but also purchases and production done abroad. Similarly, the net exposure thus calculated should be compared to the margins of each entity under consideration. The impact, for example, of a net duty of 2% of sales would depend on the entity's margin. Be that as it may, this first filter does provide some useful indications and should simplify any complementary research.

We will look in particular at how exposed **European equities are to the US**. In **two boxed insets**, we will deal with **Automobiles & Components**, a sector that regularly makes headlines, and **EU-27 exposure to the UK** in the event of a no-deal Brexit.

## The US accounts for 20% of the aggregate sales of MSCI Europe companies...

**Chart 1** shows that **sales to the US** average **20%** of MSCI Europe companies aggregate turnover. In the other direction, sales to Europe account for **14% of MSCI US** aggregate turnover, of which 12% for the EU alone. In the event of a tariff war, the US would therefore be less exposed than Europe. But it would still be heavily exposed and would also lose out if the conflict were to fester.

**However, Europe's US exposure varies widely from one country to another**, from Portugal's 2% to Switzerland almost 30%. There is less dispersion in the MSCI Europe's Big Four – Germany, France, UK, and Switzerland – which together account for 73% of Europe's market cap. Their US exposure ranges from 16% to 30% and averages 22% (weighted by their MSCI Europe weights).

As **Switzerland** is not in the EU, and as the **UK** is a special case (due, among other things, to Brexit and its status as a close ally of the US) among the Big Four, **Germany** and its famous premium cars, **looks most heavily exposed**.

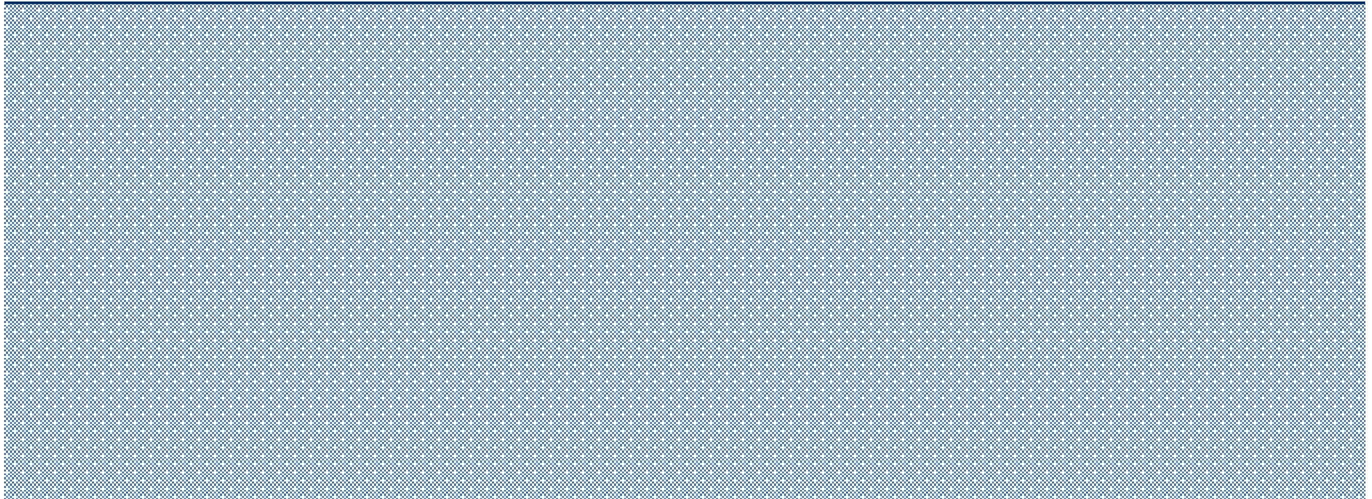
[2] *Some examples: Honda Civic, Toyota Corolla, Land Rover Evoque, Nissan Juke and Qashqai, Mini in the EU-27 and 90% of models sold in the UK.*

[3] *Liberalization of tariffs on industrial goods between the United States of America and the European Union: An economic analysis http://trade.ec.europa.eu/doclib/docs/2019/february/tradoc_157704.pdf*

[4] *EU Exit long-term economic analysis, November 2018, rapport disponible sur www.gov.uk/government /publications*

[5] *Article from V. Gunnella and L. Quaglietti published as part of the ECB Economic Bulletin, Issue 3/2019*

1/ **MSCI European indices, Sales exposure to the US in % of total**



## …. and close to 40% in some sectors!

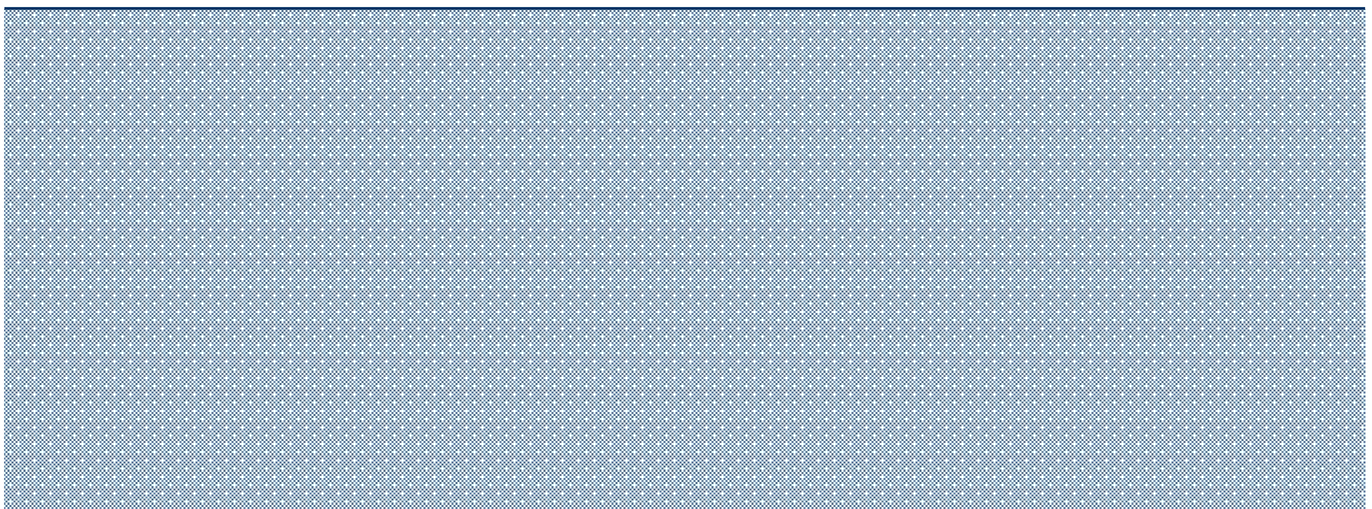
However, a more detailed look at the MSCI Europe (see chart 2), shows that, with 20% of its sales in the US, **the European auto sector is merely average.** Despite what you may have heard, it is far from being the most heavily exposed in the US. While it would take a hit from higher customs tariffs – the US is the key market for German automakers, after China[6] -- **other sectors are also at risk**.

**We are thinking in particular of Pharmaceuticals and Healthcare Equipment,** 37% and 36% of whose sales, respectively, go to the US. What's more, with elections coming up, we are certain to see the ritual campaigning over drug prices and healthcare in general. As these sectors are in normal times regarded as defensive, they may doubly disappoint if the US and Europe also engage in a tariff war.

**Four other industrial sectors are also more prominent than Automobiles & Components** – Food, Beverages & Tobacco; Tech Hardware, **Capital Goods and Household & Personal Products,** with their US sales ranging from 22% to 25% of their total.

In chart 2, we isolated services. Although some of them[7] are heavily exposed to the US, they come under a different approach as they would appear to be at little risk of customs tariffs, though, in an aggressive trade war, they could be affected by many non-tariff barriers, such as standards, certifications, legal protectionism, and extraterritoriality of US law.

2/ **MSCI Europe by industry: sales exposure to the US in % of total**



[6] *The US is the second-largest market after China, but ahead of Germany for BMW and Mercedes, and the third after China and Germany for the VW group.*
[7] *Such as customer services (hotels and restaurants) or business services (temp workers, etc.)*

## Healthcare and Capital Goods companies are generally the most exposed

Beyond the European sector average, it is also worth going one notch further on a national level. Once again, German Automobiles & Components (18%) are no more exposed than Food in Switzerland (30%); Pharmaceuticals in France (32%), the UK (35%) and Switzerland (41%); and medical equipment in Germany (46%). These sector scores are led by national champions such as Nestlé, Novartis, and Sanofi, which makes us wonder about which individual companies are the most heavily exposed.

For example, the two tables below list the **MSCI Europe's 30 manufacturing companies** with the heaviest US exposure in relative terms (as a percentage of total sales) and in absolute terms (in millions of euros of sales).

In this first **Top 30**, the percentage of **sales to the US ranges from 32% to 84% and averages 47%**, vs. 20% for the MSCI Europe. These are **large caps but not necessarily giants**. Their median size, in fact is €13bn in sales, of which €6bn in the US. By sector, **Healthcare** (12 out of 30) and **Capital Goods** (12) have the **lion's share**, far ahead of Food, Beverages & Tobacco (2) and other sectors. Of the latter, **there is only one auto sector group, Fiat**, which, as a result of its 2014 takeover of Chrysler, now makes 56% of its sales in the US. With the exception of some Fiat 500 models (38K in 2017) and a handful of Ferraris (2518 in 2017), 98% of Fiat's US sales are Chryslers. So, the group has very little tariff exposure.

**Top 30 European Manufacturing Stocks Exposure to the US (relative)**

| Rank | Company Name | Country | Classification | US Revenue 2018 (Mn Euros) | US Revenue 2018 (% of total) |
|---|---|---|---|---|---|
| 1 | Ashtead Group | UK | Capital Goods | 3,512 | 84% |
| 2 | Ferguson | UK | Capital Goods | 13,965 | 80% |
| 3 | Fresenius Medical Care | Germany | Health Care Equipment & Services | 9,788 | 59% |
| 4 | Meggitt | UK | Capital Goods | 1,380 | 59% |
| 5 | Fiat Chrysler | Italy | Automobiles & Components | 62,099 | 56% |
| 6 | Bunzl | UK | Capital Goods | 5,046 | 49% |
| 7 | UCB | Belgium | Pharma Biotech & Life Sciences | 2,266 | 49% |
| 8 | Novo Nordisk | Denmark | Pharma Biotech & Life Sciences | 7,310 | 49% |
| 9 | Smith & Nephew | UK | Health Care Equipment & Services | 1,995 | 48% |
| 10 | Roche Holding | Switzerland | Pharma Biotech & Life Sciences | 23,238 | 47% |
| 11 | BAE Systems | UK | Capital Goods | 8,718 | 46% |
| 12 | Melrose Industries | UK | Capital Goods | 4,400 | 45% |
| 13 | Lonza Group | Switzerland | Pharma Biotech & Life Sciences | 2,157 | 45% |
| 14 | Smiths Group | UK | Capital Goods | 1,595 | 44% |
| 15 | EssilorLuxottica | France | Consumer Durables & Apparel | 2,925 | 39% |
| 16 | GlaxoSmithKline | UK | Pharma Biotech & Life Sciences | 13,543 | 39% |
| 17 | British American Tobacco | UK | Food Beverage & Tobacco | 10,725 | 39% |
| 18 | Grupo ACS | Spain | Capital Goods | 14,200 | 39% |
| 19 | Skanska | Sweden | Capital Goods | 6,457 | 39% |
| 20 | Assa Abloy | Sweden | Capital Goods | 3,017 | 37% |
| 21 | Novartis | Switzerland | Pharma Biotech & Life Sciences | 14,885 | 34% |
| 22 | Husqvarna | Sweden | Consumer Durables & Apparel | 1,353 | 34% |
| 23 | Brenntag | Germany | Capital Goods | 4,235 | 34% |
| 24 | Sanofi | France | Pharma Biotech & Life Sciences | 11,540 | 33% |
| 25 | Philips | Netherlands | Health Care Equipment & Services | 6,050 | 33% |
| 26 | Siemens Healthineers | Germany | Health Care Equipment & Services | 4,458 | 33% |
| 27 | Kerry Group | Ireland | Food Beverage & Tobacco | 2,190 | 33% |
| 28 | Air Liquide | France | Materials | 6,905 | 33% |
| 29 | AstraZeneca | UK | Pharma Biotech & Life Sciences | 6,137 | 33% |
| 30 | Rolls-Royce | UK | Capital Goods | 5,698 | 32% |

## Because of their sheer size, most European champions do have heavy footprints in the US, but their relative exposure is actually rather ordinary

The second table ranks companies on the basis of their US sales in millions of euros. Thirteen of them, which are highlighted in red, are also in the previous rankings, such as Fiat-Chrysler and Roche.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However, in this second Top 30, **the profile of new entrants (Daimler, VW, Nestlé, etc.) is quite different** – their **median size is four times greater** (€51bn in total sales, vs. €13bn), but their **relative exposure is far lower** (22% vs. 47%) and is closer to the MSCI Europe as a whole (20%). Given their sheer size, it is no surprise to find **most European giants** on this list, such as BMW, Continental, Daimler, Michelin and VW in Automobiles & Components, as well as Airbus, BASF, LVMH, L'Oréal, Nestlé, Siemens and Unilever.

By sector, **this second Top 30 if far more diversified** given that, in addition to Capital Goods (8) and Healthcare (7), it also includes Automobiles & Components (6), Food, Beverages & Tobacco (3), Materials (3), Household & Personal Products (2) and Luxury Goods (1).

**Top 30 European Manufacturing Stocks Exposure to the US (absolute)**

| Rank | Company Name | Country | Classification | US Revenue 2018 (Mn Euros) | US Revenue 2018 (% of total) |
|---|---|---|---|---|---|
| 1 | Fiat Chrysler | Italy | Automobiles & Components | 62,099 | 56% |
| 2 | Daimler | Germany | Automobiles & Components | 41,152 | 25% |
| 3 | Volkswagen | Germany | Automobiles & Components | 31,856 | 14% |
| 4 | Nestle | Switzerland | Food Beverage & Tobacco | 23,920 | 30% |
| 5 | Roche Holding | Switzerland | Pharma Biotech & Life Sciences | 23,238 | 47% |
| 6 | BMW | Germany | Automobiles & Components | 16,088 | 17% |
| 7 | Siemens | Germany | Capital Goods | 16,012 | 19% |
| 8 | Novartis | Switzerland | Pharma Biotech & Life Sciences | 14,885 | 34% |
| 9 | Grupo ACS | Spain | Capital Goods | 14,200 | 39% |
| 10 | BASF | Germany | Materials | 14,062 | 22% |
| 11 | Ferguson | UK | Capital Goods | 13,965 | 80% |
| 12 | ArcelorMittal | Luxembourg | Materials | 13,792 | 21% |
| 13 | GlaxoSmithKline | UK | Pharma Biotech & Life Sciences | 13,543 | 39% |
| 14 | Sanofi | France | Pharma Biotech & Life Sciences | 11,540 | 33% |
| 15 | LVMH | France | Consumer Durables & Apparel | 11,207 | 24% |
| 16 | Anheuser-Busch InBev | Belgium | Food Beverage & Tobacco | 11,120 | 24% |
| 17 | British American Tobacco | UK | Food Beverage & Tobacco | 10,725 | 39% |
| 18 | Bayer | Germany | Pharma Biotech & Life Sciences | 9,793 | 25% |
| 19 | Fresenius Medical Care | Germany | Health Care Equipment & Services | 9,788 | 59% |
| 20 | Airbus | Netherlands | Capital Goods | 9,428 | 15% |
| 21 | BAE Systems | UK | Capital Goods | 8,718 | 46% |
| 22 | Continental | Germany | Automobiles & Components | 8,646 | 19% |
| 23 | Unilever | UK | Household & Personal Products | 8,305 | 16% |
| 24 | Volvo | Sweden | Capital Goods | 8,246 | 22% |
| 25 | Novo Nordisk | Denmark | Pharma Biotech & Life Sciences | 7,310 | 49% |
| 26 | Schneider Electric | France | Capital Goods | 7,044 | 27% |
| 27 | Air Liquide | France | Materials | 6,905 | 33% |
| 28 | Michelin | France | Automobiles & Components | 6,818 | 31% |
| 29 | L'Oreal | France | Household & Personal Products | 6,649 | 25% |
| 30 | Skanska | Sweden | Capital Goods | 6,457 | 39% |

## To sum up

**Given the extent of reciprocal links between the US and the EU, both would be losers in a trade conflict. Although on a pure trade basis Europe is most heavily exposed, when services, investments and repatriation of profits are factored in, the relationship is almost perfectly in balance and perhaps even to the US's advantage. Even so, given that goods are more easily taxed than services, Europe would be the first to bear the brunt of increased tariffs. While European Automobiles & Components already appear to have been convicted by a jury of tweets, this is not the sector with the heaviest US exposure and, moreover, has many counter-arguments in its defence. However, other sectors – including healthcare, capital goods, and food, beverages & tobacco – which are less subject to media hype but also have large US footprints, are worth greater attention and a more in-depth review.**

## Automotive sector: A usual suspect which is worth a second look

Although singled out on a regular basis, German **automotive champions don't just export to the US**; they also have a very heavy manufacturing footprint in the US itself and are a big employer in the southern states, which traditionally vote Republican.

**Taken as a whole, the three German auto groups** – VW, Mercedes and BMW – **in 2017 had a sales-to-local manufacturing ratio** (i.e., the number of vehicles produced locally divided by the number of total cars registered) of **61%** in the US and as much as **115% in the case of BMW**.

As a matter of fact, BMW has been on the ground in the US since 1994, and its **largest plant in the world** is located in Spartanburg, South Carolina; this is also its only plant producing all of its large SUVs, from the X3 to the X7.

At the other extreme, with a sales-to local manufacturing ratio of just 21% in the US (of which 38% for the VW brand, but 0% for Audi and Porsche), **the VW group is behind its peers**. However, as NAFTA is still largely valid (now renamed USMCA), this is offset by its heavy manufacturing footprint in Mexico, which gives it a ratio of 75% for all three NAFTA countries. However, to avoid alienating US decision-makers, VW has announced that it will ramp up its **Chattanooga, Tennessee**, plant, hire an additional 1000 persons there, and invest $800m to produce its **future electric VW.**

| 2017 (000'0) | US Production | US Sales | US coverage rate | Mexico Production | Total Production ALENA | ALENA Sales | ALENA coverage rate | ALENA plants | Main models |
|---|---|---|---|---|---|---|---|---|---|
| **VW Group** | **130** | **624** | **21%** | **600** | **730** | **972** | **75%** | Chattanooga (Tennessee) | VW Passat, SUV VW Atlas, future electric VW. |
| VW | 130 | 340 | 38% | 520 | 650 | 602 | 108% | | |
| Audi | - | 227 | - | 80 | 80 | 278 | 29% | Puebla (Mexico) | VW Tiguan, Golf, Jetta, New-Beetle, Audi Q5 |
| Porsche | - | 55 | - | - | - | 65 | - | | |
| **Mercedes** | **287** | **372** | **77%** | **0** | **287** | **442** | **65%** | Tuscaloosa (Alabama) | GLE, GLS, Classe C |
| **BMW-MINI** | **405** | **353** | **115%** | **0** | **405** | **421** | **96%** | Spartanburg (South Carolina) | World exclusive from the X3 to the X7 |
| BMW | 405 | 306 | 132% | 0 | 405 | 360 | 113% | | |
| MINI | - | 47 | - | - | - | 60 | - | | |
| **Big 3 German** | **22** | **1,349** | **61%** | **600** | **1,422** | **1,835** | **77%** | | |

## Brexit: A limited challenge for the EU's 27 companies, a much bigger one for UK companies

In addition to a tariff war with the US, the EU could soon be facing another trade problem if the UK were to split off from it without an agreement, as this would automatically trigger tariffs provided under WTO rules. To compare the challenges for equity markets, we used the same set of indicators as for the US.

**Regarding the EU-27, the problem should be of a lesser extent than for the US** as the aggregate UK sales of the MSCI Europe ex-UK is just 5.7%, or three times lower than US sales (17.3%).

**However, the UK's dependence on the EU-27 is far greater** (at 16.7% of aggregate sales of the MSCI UK) and almost the same as US sales (23.4% of the aggregate sales of the MSCI UK).

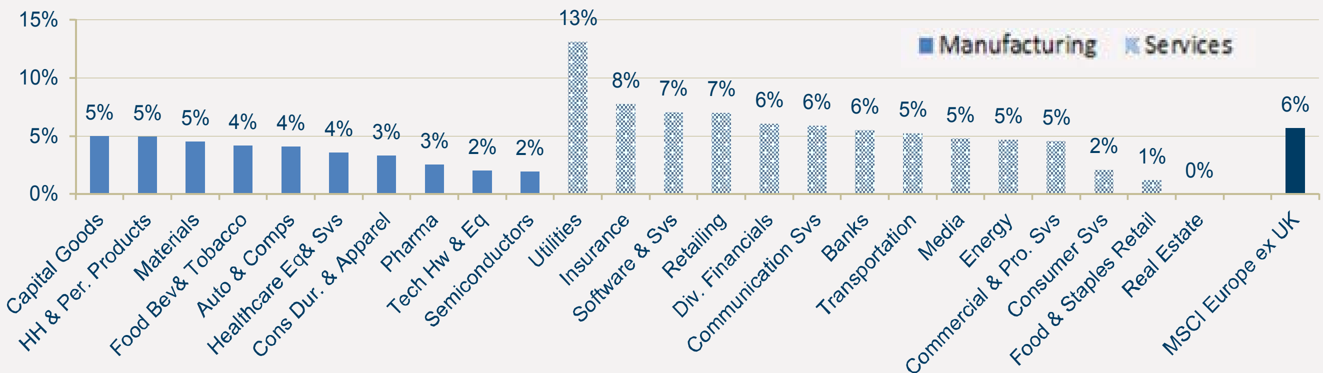
**This relatively low dependence of the EU 27 on the UK also shows up by sector (table 3).** Just one sector, Utilities, makes more than 10% of its sales in the UK. And even this percentage comes with the caveat that gas and electricity suppliers are, by essence, local players, whether through organic growth or acquisitions.

Looking back at our distinction between manufacturing and services, with the former being more easily taxable and the second more vulnerable to non-tariff barriers, we find that **none of the 10 industrial sectors exceed 5% exposure in the UK**, while seven of them range between 20% and 37% vis-à-vis the US.

**Individual companies, however, may have far heavier UK exposure.** Tables 4 and 5 on the next page sum up UK exposure for all sectors combined. The first Top 30 companies are ranked by percentage of total sales and the second in terms of absolute value. Average exposure of the first top 30 surges to 21.5% from 5.7% for the companies on the whole, a far more impactful figure. By country, there are many German (7), Nordic (6), Spanish (6) and Irish (5) companies, but few French ones (3), although it's true that Getlink (the ex-Eurotunnel) unsurprisingly dominates the rankings, at 50% of its sales. Alongside manufacturing companies (7) are many services companies, in finance (9) and utilities (7).

The second ranking (table 5) sums up the 30 non-UK companies with the **heaviest absolute UK exposure**. Out of these 30 companies, 11 were already been included in the relative rankings. The 19 others include **most European champions** (Allianz, BASF, Nestlé, Siemens, Total, Unilever, etc.), and in particular Automobiles & Components giants (VW, Daimler, BMW, Renault, Peugeot, Fiat-Chrysler), with average sales of **€80bn**. Even so, in relative terms, these 19 champions are far less exposed to the UK, at **6.1% on average vs. 22.2%** for the other 11.

## 3/ MSCI Europe ex-UK by industry: sales exposure to the UK in % of total



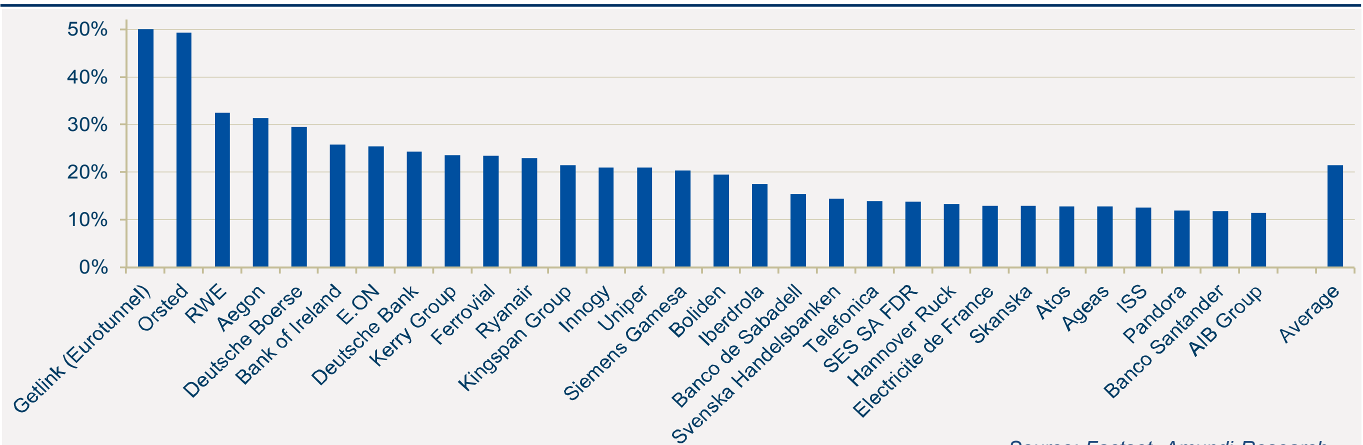

*Source: Factset, Amundi Research*

These 30 companies are mainly from Germany (13) or France (8), ahead of Spain (3), Italy and Switzerland (2), Denmark and the Netherlands (1).

All in all, after more than 45 years of living together, the UK has formed a large number of links with the rest of the EU. In the event of a hard Brexit, there will be a temporary leap into the unknown, followed, ultimately, by long negotiations that will also cover services. Given both sides' mutual interests and neighbourly relations, this should ultimately lead to **reasonable compromises**.

## 4/ Top 30's Companies exposed to the UK (relative terms)

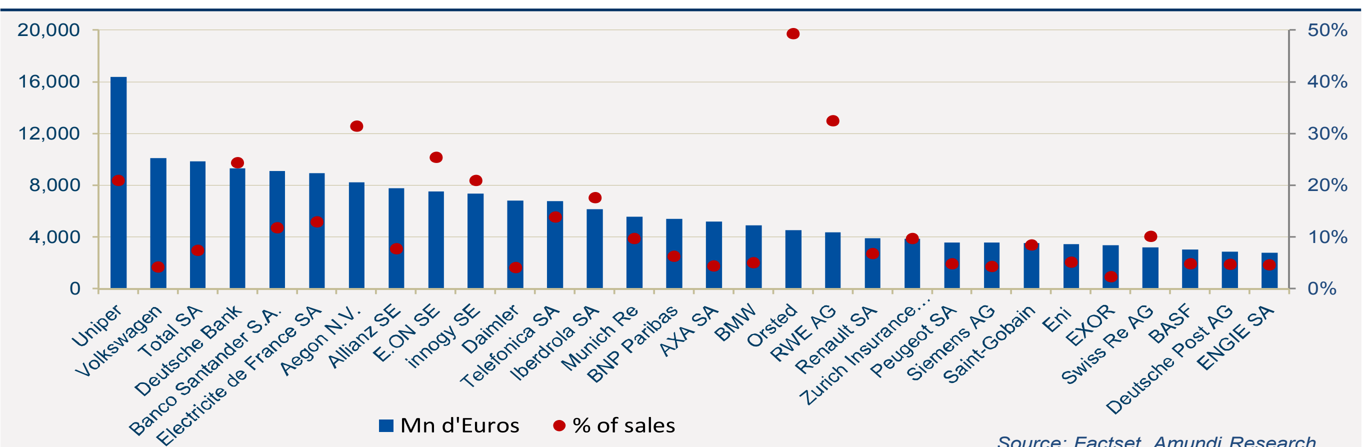
European non-UK stocks relative exposure to the UK (% of total Sales)




*Source: Factset, Amundi Research*

## 5/ Top 30's Companies exposed to the UK (absolute terms)

European non-UK stocks exposure to the UK (classified by UK Sales in Mn Euros)




*Source: Factset, Amundi Research*

# 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 | Major European slowdown

**Analysis |** The Eurozone economic momentum has been difficult to decipher since the beginning of 2019, as very weak manufacturing surveys contrasted sharply with much more robust services and labour market data that pointed to a continuation of the recovery. So far, spillovers from the manufacturing shocks (mostly related to specific difficulties in the car sector and trade uncertainties caused by US protectionism and the hard Brexit risk) to the rest of the economy have been limited. However, this situation could change should manufacturing not recover, or deteriorate further, in the coming months. One of the potential triggers for such a situation would be a hard Brexit, whose risk has however been presumably delayed to at least October 2019. On the other hand, new US tariffs on European goods are a possibility that cannot be ignored and would have very detrimental effects (through uncertainty and trade) on European industry, raising the probability of an economy-wide slowdown.

**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 # 2 | 15% probability | Renewed escalation in trade tensions between the US and China

**Analysis |** The US announced it would 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 focus on core topics, including structural issues and enforcement, as well as technical details. If additional progress could be achieved, there could be potentially another Trump/Xi meeting, and the probability for US/China to reach some kind of deal to avoid tariff increase and to prevent further escalation would be appreciably higher than in late 2018. This seems to be helping reduce some downside risks in the near term, and to have helped market sentiment recover somewhat. That said, uncertainty remains relatively high, and it could take much longer to ultimately solve the problems, as many complicated issues are involved. We cannot yet rule out a severe confrontation between the US and China.

**Market impact |** Tariffs have started to hit trade, and uncertainty has 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 into 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 # 3 | 15% probability | No-deal Brexit

**Analysis |** The Heads of State reached agreement (11 April) after heated discussions on the length of the extension. The date of 31 October is presented as a deadline. We identify 3 families of scenarios (with several options in each). It is too early to say more. We must continue to closely monitor the positions taken by MPs and the government. The probabilities below are above all indicative and subject


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to change insofar as the political situation can change rapidly. We see 3 scenarios (S1, S2 and S3).
**S1 (50%). Deal before the new deadline (20% ratification before 22 May, 30% after 22 May and before 31 Oct).** The domestic pressure to reach a deal will remain strong in the coming months. Indeed, the British are exasperated (and the MPs too). The economy has weakened due to uncertainty. If current negotiations with the Labour fail, Theresa May continues to promise “soon” (subject to Labour agreement) a series of (binding) indicative votes: this is the official ‘plan B’. In that case, keep in mind that a solution might be found within just a few days or weeks. Moreover, even if the date of 30 June is not mentioned in the resolution, the end of June is politically important and symbolic for at least two reasons: (1) because progress will be reviewed at the next European council (20-21 June) and (2) because the new MEPs (if elected) would not sit in Parliament until 2 July (the date on which the MEPs will take office).

**S2 (35%). Prolonged extension beyond 31 Oct.** Although this option is a priori (firmly) excluded, we believe that some choices (referendum or elections for instance) – if decided late – would require an additional delay. Under new conditions, EU countries (and in particular France) would reconsider their (its) position. It’s all the more likely that there’s no strong rationale behind this new deadline. It was only set to maintain pressure on the UK and it is the result of compromise.

**S3 (lowered from 20% to 15%). No deal.** The flexible nature of the extension makes an accidental ‘no deal’ even less likely (i.e. the ‘disorderly Brexit’ has a lower probability). Bear in mind that the ‘no deal’ is still rejected by a large majority of MPs (of which a growing part of Tories) and by the vast majority of the EU countries. Subsequently, a ‘no deal’ would be a ‘managed no deal’. Indeed, given the uncertainty, there is a strong incentive to continue to prepare for this scenario.

**Market impact |** Uncertainty is likely to rise approaching the new deadline (31 Oct) and to drop again if another extension is secured. In the event that the outcome is unfavourable for the UK, we would see a weakening of the GBP and below-trend GDP growth. But should a deal be approved sooner than expected, sterling would re-appreciate and business investment would probably benefit from a drop in uncertainty. The situation remains very binary and thus not very conducive to strong portfolio recommendations.

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

**Analysis |** In early April the Italian Government released the latest economic blueprint (SGP), embedding the new forecast for the 2020 budget and beyond. Projections seem to come closer to consensus, implying weaker growth and worse public finances. Growth projections expect the Italian economy to expand at 0.2% YoY in 2019, followed by 0.6% in 2020. Deficit /GDP target is now set to 2.4% for 2019, gradually declining towards 1.5% in 2022. Yet, due to the combination of worsening of growth profile, reduction in primary surplus and increase in deficit projections, the Debt to GDP ratio is expected to increase from 132.2% in 2018 to 132.6% in 2019. Target for 2022 is set to 128.9%. The path towards a reduction in deficit and debt is predicated on growth returning gradually towards potential and measures successful to contain public spending. Rating agencies recently did not change their assessment although highlighting key risks on the debt path. Even though in the short-term and before European Parliament election it may be unlikely to see a confrontation with the EC, with slow growth ahead, tensions related to debt sustainability concerns may likely arise in the future, should any fiscal slippage materialise and become evident.

**Market impact |** There is no systemic risk in our opinion. On the one hand, rising Italian bond yields have tightened local financial conditions, and that is weighing on GDP growth in Italy. But on the other hand, the absence of an EDP has provided 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 contagion to other peripheral markets. In addition, the ECB has announced new TLTROs to alleviate difficulties in the banking system. All of this should contain the contagion risk on peripheral sovereign spreads and corporate credit spreads.

## Risk # 5 | 15% probability | US recession

**Analysis |** The US economy was stronger than expected in Q1 (+3.2% YoY, after closing 2018 at 3.0%), according to the preliminary estimate. Yet, behind the strong headline number, signs of deceleration in domestic demand confirm our outlook for a progressive slowdown in the second half of the year, as we

expect the impact from the fiscal stimulus to fade. In fact, in Q1 two key drivers posted a weak reading: personal consumption expenditures (especially in the key durables goods component) and investments (in the key equipment component) decelerated. Personal Consumption momentum decreased on a quarterly basis, but the annual trend holding up well amid signs of pick-up from retail sales in March and consumer fundamentals remain still supportive to our outlook. Non-residential investments broadly decelerated and, albeit broadly in line with our outlook, the sharp deceleration in equipment investments calls for close monitoring. Net trade contributed alone to 1% of GDP growth, thanks to a contraction in imports, something that may be reversed in Q2. Finally Government consumption increased solidly as the Bipartisan Budget Act still deploys some effects. 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 for 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 asset classes started 2019 buoyantly, thanks to (1) the Fed's U-turn in communication ("wait and see" attitude on interest rates revising the dots, stabilisation of its balance sheet by Q3 2019); (2) a more negative news-flow concentrated in DM (Europe in particular); and (3) a less likely escalation in the trade war between the US and China with likely a deal between the two. Having said that, the contagion risk in the EM world remains well alive whether through real economy spillovers (overall weaker global growth will reflect in weaker global trade and less external demand for EM economies) or through financial markets spillovers. The Federal Reserve stance shift has been quite earlier and stronger than anticipated in our 2019 outlook and the risk of a monetary policy mistake by the main central banks remains non negligible. Indeed, today we do see the risk of contagion through financial market higher than through the chain trade. As long as the global financial environment remains dovish, the contagion risk coming from the usual fragile suspects like Turkey and Argentina remains limited; however, should the global environment change towards a tighter one, the contagion risk would increase.

**Market impact |** Spreads and equity markets would once again be highly hurt; it is all the truer 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 or fragile fiscal and political conditions. Some caution on 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 (through monetary and fiscal policies) so that the economy will 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, and 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 the trend in Chinese private debt closely, especially if the economy slows. Meanwhile, the de-escalation in trade tensions should give China policymakers time to adjust their policy implementations and to better manage short-term risks. In the event of a 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 bursting 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 at some point 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 in late 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).

In Spain, the result of the April elections was generally in line with what could be expected from the polls: The PSOE (Socialist) Party of PM Sánchez came first, securing a large increase in its number of MPs. Even though the PSOE has no majority, there is no imminent threat to political or economic stability. 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. At this stage we believe, as most observers do, that far-right parties will make some progress and that the two traditional mainstream parties (the Social-Democrats and Christian-Democrats) will lose the combined majority that they have had since the creation of the European Parliament. However a "pro-institution" majority can nonetheless probably still be built, although with some additional delays and negotiations, by working with parties at the center or with the Greens. Thus, we do not see these elections as triggering a new systemic crisis in the Eurozone in 2019, although they may give even more impetus to those anti-institutional forces that will make subsequent national elections less predictable.

**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, we cannot rule out some 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

DIDIER BOROWSKI, Head of Macroeconomic Research
PHILIPPE ITHURBIDE, Global Head of Research

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

### Central scenario (75% probability): end of the soft patch in sight, more decoupling looking ahead

- **Growth has slowed worldwide:** 2018 had begun based on the theme of a synchronised global recovery. But this did not last. Since spring 2018, the protectionist measures taken by Donald Trump have changed the game. Emerging economies, some of which are heavily indebted in dollars, were weakened last year by the broad-based appreciation of the USD. Moreover, economic activity has weakened markedly in the Eurozone since Q4 2018. Hence, 2019 has begun with a global synchronised slowdown with risks remaining tilted to the downside. We however believe that the pronounced soft patch is over.
- **Global trade:** Global trade has fallen over the past 18 months; it started 2018 at around 5% yoy but fell sharply in Q4 2018 and slipped further in Q1 2019 (from +0.1% yoy in Jan to -1.1% yoy in Feb). The economic slowdown in China probably played a role in late 2018. But most importantly, the protectionist rhetoric has pushed uncertainty to an all-time high (with a peak in Jan), dragging down investment. On the one hand, the de-escalation on trade between China and the US bodes well, but on the other hand a trade war between the EU and the US remains a distinct possibility. At this stage, we however continue to expect global trade growth to stabilise at around the level of global GDP growth (i.e. we would expect global trade to return to around 3% yoy by early 2020).
- **United States:** The US economy has been driven by a very accommodative fiscal policy; its impact should progressively erode this year. True, real GDP growth was well above expectations in Q1 19 (3.2% qoq at annual rate after 2.2% in Q4 18). This was the third quarter the US economy grows at a rate above 3% in the last 5 quarters. GDP growth also picked on a year on year basis from 3.0% in Q4 18 to 3.2% in Q1 19. Yet, nominal GDP growth slowed from 4.1% qoq (ar) in Q4 to 3.8% in Q1. And looking at the composition of quarterly growth, domestic demand slowed sharply (both household consumption - especially in durables goods - and investment in equipment decelerated). Due to very accommodative monetary and financial conditions, we however revised slightly higher our GDP growth forecast for 2020 from 1.8% to 2.0%. We continue to expect growth to decelerate to its potential in 2020 but at a very gradual pace. Corporate profits will remain under pressure, especially if inflation re-accelerates, which is still possible, given that the economy is operating at close to full employment. We do believe that a recession is highly unlikely in 2019 and in 2020 (as household consumption should continue to benefit from higher disposable income). However, doubts about the extension of this cycle are likely to rise in the coming quarters (less support from fiscal policy, domestic demand under pressure, mixed signals from sentiment and hard data). And we must keep in mind that sub-par growth may trigger a profit recession.
- **Eurozone**: The data for Q1 has been mixed, with some figures improving, but also some persistent weakness in manufacturing. Although they began recovering well after the US, Eurozone economies began to slow in 2018, much more sharply than other economies. Several transitory factors have contributed to the slowdown in EZ growth. Germany was close to falling into recession in Q4, due to an abrupt slowdown in world trade, disruptions in the auto sector caused by new pollution tests, and weakness in the manufacturing sector. The late-2018 shock to the EZ manufacturing sector 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 (Brexit, Italian budget) have muddied the waters. However, we believe the level of pessimism is excessive and we stick to the view that domestic demand (in particular consumption) will remain supported by the labour market, strong income growth, the level of monetary policy

accommodation, and a significant fiscal stimulus (especially in Germany and France). Subsequently, we believe that growth will gradually reaccelerate. The May 2019 European elections coupled with the threat of US tariffs on European autos will likely maintain uncertainty at a high level. While we believe that mainstream parties will dominate the European Parliament, populist/anti-system parties will gain ground and 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 at the earliest.

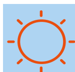
- **United Kingdom:** The political situation in the UK is highly unstable. The UK government and the EU have agreed on a new deadline (31 Oct) to fix the problem; all options remain on the table. Everything will ultimately depend on the scenario (see the 'risk factors' section for scenarios with indicative probabilities). We continue to believe that the probability of a deal is far above the probability of a no-deal. And with a deal, we would expect a rebound in domestic demand with diminishing uncertainty.
- **China:** China's headline data for March and Q1 broadly surprised on the upside, even more than we had expected. When coupled with recent credit and trade data, we do see enough positive signs to revise our forecasts. We revised up our GDP growth forecast from 6.2% to 6.3% (2019), and from 6.1% to 6.2% (2020). We also revised up slightly our inflation forecasts. In other words, we are close to bottom for both real and nominal GDP growth. Policymakers are not likely to ease further, but they are still working on targeted measures to support SMEs and consumers, which are slower to take effects and supposed to be healthier. That said, all measures are still on the table if and when necessary. Indeed the country's economic model remains fragile: the excess of credit is visible, and non-financial corporate debt has surged since the GFC.
- **Inflation:** Core inflation remains low 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. In theory, an "inflationary surprise" remains possible with the pick-up in wages (in the US and the Eurozone) but it is striking to see that inflation slowed in the US in Q1 19 just as real GDP growth accelerated! In the Eurozone, in a low inflation environment, we consider that corporates have almost no pricing power (i.e., corporate margins more at risk than final sale prices). In emerging economies, inflation had recently slowed more than expected, but this was mainly due to the decline in energy and food prices. The recent rebound in oil prices should not last long. At the end of the day, with low inflation and subdued growth, most central banks have turned more dovish since the start of the year.
- **Oil prices:** Rollercoaster has continued after OPEC cut production by 3 million barrels a day, the most significant cut since the GFC. Oil is still mainly driven by supply factors. On the one hand, OPEC and supply disruption concerns in Venezuela, Iran and lately Libya support oil prices in the short run, on the other hand, the expected rise in US shale oil production should weigh on oil prices. The surprise announcement by the US administration that the US is ending waivers allowing several countries to keep importing Iranian crude has pushed up oil prices to $75 (Brent). True, the objective of the US administration is to drive Iran's oil exports down from the current level of around 1.5 million barrels a day to close to zero and the waivers expire on 2 May. However, the White House also announced a close coordination with Saudi Arabia and the United Arab Emirates to avoid market disruption (they have the means to compensate for the fall in Iranian exports). In addition, OECD oil inventories (end of February 2019) were at 2.9 million barrels, which is above the five-year average. All in all, we are thus sticking to our range target of $60-70 (Brent). Oil prices may remain however volatile.
- **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 2019. The ECB ended its monthly asset purchases in late December and will continue to replace maturing securities. For the ECB, we expect a status quo (regarding interest rates) in 2019 and 2020. The ECB has no room for manoeuvre to normalise its monetary policy, given the economic slowdown and the absence of inflation. The ECB announced new TLTROs in March (to come in September, with the technicalities probably announced in June) and surprised with its dovish stance: The ECB may ease further if growth slows further. A two-tiered system is being seriously considered for the deposit rate, to alleviate the burden on banks that have very large excess reserves (Germany).

## 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) weigh heavily on global demand.

**Consequences:**

- All things being equal, a trade war would drag down global trade and trigger a synchronised and sustained 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 fears in the US.
- Under a worst-case scenario, CBs could once again resort to unconventional tools, such as expanding their balance sheets (particularly true for the ECB).



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

**Donald Trump makes an about-turn, reducing barriers to trade. 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 reaccelerates in the Eurozone after a pronounced soft patch. Growth picks up again in China on the back of a stimulative policy mix.
- Central banks 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

### Normalisation progresses

- As the fiscal boost fades, key drivers of domestic demand are slowing progressively and getting closer to long-term trends gradually, as monetary policy and financial conditions smooth and accompany this normalisation.
- US consumers remain upbeat in general. Still-dynamic labour demand and wage growth, coupled with contained inflationary pressures, support resiliency in personal consumption, which is expected to be the main driver of domestic demand.
- Business confidence has moderated appreciably compared to last year among small and larger businesses, and this reflects a moderation in capex intentions and investments, which anyhow remain in line with our outlook.
- Moderate domestic and external inflationary pressures are keeping both core and headline CPI in check and somewhat subdued, composing a benign inflation outlook. The Federal Reserve is not expected to deliver further rate hikes this year, will end QT, and will remain alert to any changes in financial conditions, economic outlook and inflation dynamics

**Risk factors**

- Concerns over global growth and external and domestic demand may hold back new capex plans more than expected
- Tariffs risks may negatively impact economic performance, both directly (in prices and orders) and indirectly (in confidence)
- Geopolitical risks linked to a more hawkish shift by the US administration

## Eurozone

### A gradual improvement expected despite considerable risks

- After a highly disappointing 2018, figures have so far been mixed in 2019. However, while most of the difficulties involve export-intensive (manufacturing) sectors, the job market is holding up well and is likely to support consumption and services. We expect a gradual improvement during the rest of 2019.
- The risk of a no-deal Brexit has become less imminent, but there is still the threat of US trade measures against Europe. Moreover, there are still some considerable political uncertainties, particularly the upcoming European elections and the situation in Italy.

**Risk factors**

- Stronger political protest movements
- External risks (trade war, slowdown in the US and China)

## United Kingdom

### Major uncertainty as Brexit approaches

- Brexit is undermining confidence and investment. The United Kingdom has won an additional Brexit extension from the European Union (till 31 October), but the domestic political situation could be volatile in the coming months. The UK's participation in European elections could generate tensions, and a change of government, new elections or the holding of a new referendum are all possible scenarios.
- 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

### Out of the woods, but still on a bumpy road

- Global economic stagnancy has crippled manufacturers, with exports marking a y/y fall for four months. The BoJ corporate survey points to decent capital spending plans for 2019. In fact, sluggish shipments are undermining investment. Machinery orders showed only a meagre gain in February after three months of contraction.
- However, non-manufacturers held up well on urban redevelopment, job placement and the coming 5G Telecom standard. Despite the weak export snapshot, shipments are likely to gather strength as the Chinese economy rebounds solidly.
- On the consumer front, settled pay raises are slightly higher than last year. Nonetheless, a 2% increase in disposable income is being partly offset by a higher savings rate, reflecting households' apprehension over corporate earnings and the upcoming VAT tax hike. They are also being discouraged by higher consumer staple prices.

**Risk factors**

- Further rise in oil price could hamper corporate and consumer activities
- Companies may reduce / postpone business investment on a slow recovery in corporate earnings

## China

- Economic activity recovered some strength after a poor performance ahead of the Chinese New Year. With policy gradually taking effect, growth seems to be near bottom. Credit growth is bottoming out, while fiscal spending has been accelerating.
- Already, local orders are recovering, as PMI data implied. The latest data also suggested that the auto and smartphone sectors, which were major drags in H2 2018, are past the worst time.
- The property sector is holding up better than expected and the slowdown ahead could be manageable, with further relaxation of Hukou and policy easing at a local level.
- Meanwhile, exports in the region have avoided another sharp slowdown for now, after a bad Q4.
- The RMB is seeing slight upward pressures, helped by a resilient growth outlook and a dovish Fed.
- US/China trade negotiations showed further positive progress, with possible results in the next few weeks.

### 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)

- Growth dynamics continued to be very weak, mainly in the first two months of the year. On the exports side, figures have been less negative since March (in South Korea, India and Indonesia).
- The region's inflation figures remained very benign. Oil and food prices pushed inflation to levels lower than expected. In India, inflation remains very benign (2.9% YoY), but March data showed some inversion towards higher food prices.
- Overall, CBs in the region are in a wait-and-see mode before shifting towards a more dovish stance, thanks to a more favourable global financial environment. India cut its policy rates by a further 25bps.
- While waiting for final elections results in Thailand (announced after the 9th of May), the region is holding new electoral campaigns (India just started and Indonesia).

### Risk factors

- **Export dynamics weakness eased in March**
- **Inflation still very benign. India inflation increased in food prices.**
- **Central banks in the region in wait-and-see mode. India cut rates again.**
- **Election outcome in Thailand not final yet. India and Indonesia holding elections.**

## Latam

- Mexico and Brazil continue to experience two soft patches in terms of economic growth. However, differently from each other. Mexico is expected to decelerate in 2019 versus 2018 while Brazil is expected to slightly accelerate.
- On the inflation front, the overall environment remains benign. In March, Mexican inflation went back up to 4% from the 3.9% previously published (Banxico target range is 2%-4%). In Brazil, inflation jumped to 4.6% YoY from 3.9%.
- The region's main central banks left their monetary policy rates unchanged. We see Banxico starting the easing process if the domestic policy uncertainty reduces.
- In Brazil, the new president and his economic team decided to present a very bold pension reform plan to Congress. The first vote by the Constitution and Justice Committee in the lower house is scheduled to take place by April but will probably be further delayed.

### Risk factors

- **Better economic conditions in smaller countries**
- **Inflation is benign overall, with Mexican inflation back within Banxico's target range**
- **We expect Banxico to ease if there is less policy uncertainty**
- **The very bold pension reform announced in Brazil is at risk of delay**

## EMEA (Europe Middle East & Africa)

**Russia: Real GDP growth was 2,3% in 2018 and should be slightly lower in 2019. However, 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 has kept its key rates on hold, but we expect a rate cut in Q4.

**South Africa: exit from recession but no miracle**

- This month Moody's decided not to downgrade the Sovereign note which gives some respite to South Africa at least until November. However, due to the weakness of high frequency data and the slowdown of global growth, we have downgraded our forecast for this year (2019) to 1.4% yoy from 1.7% previously.
- Despite a weak economic and subdued inflation environment and a dovish Fed, we expect the SARB to remain cautious and to keep a neutral stance at least for the first half of the year.

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

- High Frequency Data released so far for Q1 2019 are still very weak. However, some improvements have materialised in manufacturing PMI, industrial production, retail sales etc. The worst could be behind us. We forecast real GDP growth to be -1.5% in 2019 and +1.5% in 2020.
- The CBRT is still under pressure, with CPI inflation set to remain high and pressures on the currency to continue in an unfavourable political environment.

### Risk factors

- **Drop in oil prices, stepped-up US sanctions and further geopolitical tensions**
- **Increased risk aversion, risk of sovereign rating downgrading, rising social demands in the run-up to elections and risk of fiscal slippage**
- **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
(25 April 2019)

| Annual averages (%) | Real GDP growth % | | | Inflation (CPI, yoy, %) | | |
|---|---|---|---|---|---|---|
| | 2018 | 2019 | 2020 | 2018 | 2019 | 2020 |
| **US** | **2.9** | **2.4** | **2.0** | **2.4** | **2.0** | **2.4** |
| **Japan** | **0.8** | **1.0** | **0.7** | **1.0** | **0.7** | **1.3** |
| **Eurozone** | **1.8** | **1.0** | **1.5** | **1.8** | **1.2** | **1.5** |
| Germany | 1.4 | 0.8 | 1.5 | 1.7 | 1.5 | 1.5 |
| France | 1.5 | 1.3 | 1.5 | 2.1 | 1.3 | 1.5 |
| Italy | 0.8 | 0.1 | 0.6 | 1.1 | 1.0 | 1.5 |
| Spain | 2.5 | 2.0 | 1.8 | 1.7 | 1.6 | 1.9 |
| **UK** | **1.4** | **1.1** | **1.4** | **2.4** | **2.2** | **2.2** |
| **Brazil** | 1.1 | 2.0 | 2.3 | 3.7 | 4.2 | 4.6 |
| **Russia** | 2.2 | 1.5 | 1.7 | 2.9 | 4.8 | 4.0 |
| **India** | 7.3 | 6.4 | 6.9 | 4.0 | 3.6 | 4.6 |
| **Indonesia** | 5.2 | 5.3 | 5.3 | 3.2 | 3.2 | 4.0 |
| **China** | 6.6 | 6.3 | 6.2 | 2.1 | 2.2 | 2.5 |
| **Turkey** | 2.9 | -1.5 | 1.5 | 16.2 | 15.4 | 12.9 |
| Developed countries | **2.2** | **1.7** | **1.7** | **2.0** | **1.6** | **2.0** |
| Emerging countries | **4.9** | **4.6** | **4.8** | **4.1** | **3.7** | **3.8** |
| World | **3.8** | **3.4** | **3.6** | **3.2** | **2.9** | **3.1** |

*Source: Amundi Research*

## Key interest rate outlook

| | 26/04/2019 | Amundi + 6m. | Consensus Q3 2019 | Amundi + 12m. | Consensus Q1 2020 |
|---|---|---|---|---|---|
| **US** | 2.50 | 2.50 | 2.50 | 2.50 | 2.50 |
| **Eurozone** | 0 | 0 | 0 | 0 | 0 |
| **Japan** | -0.1 | -0.1 | -0.1 | -0.1 | -0.1 |
| **UK** | 0.75 | 0.75 | 0.75 | 1.00 | 1.00 |

## Long rate outlook

### 2Y. Bond yield

| | 26/04/2019 | Amundi + 6m. | Forward + 6m. | Amundi + 12m. | Forward + 12m. |
|---|---|---|---|---|---|
| **US** | 2.31 | 2.20/2.40 | 2.24 | 2.20/2.40 | 2.22 |
| **Germany** | -0.6 | -0.60/-0.40 | -0.60 | -0.60/-0.40 | -0.58 |
| **Japan** | -0.16 | -0.20/0.00 | -0.15 | -0.20/0.00 | -0.17 |
| **UK** | 0.73 | 0.60/0.80 | 0.72 | 0.70/0.90 | 0.75 |

### 10Y. Bond yield

| | 26/04/2019 | Amundi + 6m. | Forward + 6m. | Amundi + 12m. | Forward + 12m. |
|---|---|---|---|---|---|
| **US** | 2.52 | 2.50/2.70 | 2.55 | 2.40/2.60 | 2.58 |
| **Germany** | -0.02 | 0.05/0.20 | 0.04 | 0.05/0.20 | 0.10 |
| **Japan** | -0.05 | 0.00/0.10 | -0.06 | 0.00/0.10 | -0.03 |
| **UK** | 1.14 | 1.10/1.30 | 1.26 | 1.15/1.35 | 1.31 |

## Currency outlook

| | 19/04/2019 | Amundi + 6m. | Consensus Q3 2019 | Amundi + 12m. | Consensus Q1 2020 |
|---|---|---|---|---|---|
| **EUR/USD** | 1.12 | 1.14 | 1.14 | 1.17 | 1.18 |
| **USD/JPY** | 112 | 110 | 110 | 106.5 | 108 |
| **EUR/GBP** | 0.86 | 0.86 | 0.85 | 0.85 | 0.85 |
| **EUR/CHF** | 1.14 | 1.14 | 1.13 | 1.15 | 1.15 |
| **EUR/NOK** | 9.56 | 9.45 | 9.50 | 9.40 | 9.40 |
| **EUR/SEK** | 10.46 | 10.30 | 10.33 | 10.20 | 10.17 |
| **USD/CAD** | 1.34 | 1.32 | 1.32 | 1.30 | 1.30 |
| **AUD/USD** | 0.72 | 0.72 | 0.72 | 0.70 | 0.73 |
| **NZD/USD** | 0.67 | 0.67 | 0.67 | 0.66 | 0.68 |
| **USD/CNY** | 6.71 | 6.70 | 6.70 | 6.60 | 6.66 |

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## NOTES

## NOTES

## NOTES

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High Yield

May 2019 #05

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