Monthly | Finalised at 3 July 2019

July/August 2019 **# 07/08**

Confidence must be earned

Amundi
ASSET MANAGEMENT

CROSS ASSET

INVESTMENT STRATEGY

CIO VIEWS

CENTRAL BANKS FUEL MARKETS: ILLUSION VS REALITY

THIS MONTH'S TOPIC

ITALY: A LONG AND WINDING ROAD

Research & Macro Strategy

CIO VIEWS

Central banks fuel markets: illusion vs reality

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

The journey from market complacency to awareness of fragilities is in full swing, and the market correction in May is part of that, as is the recent recovery fuelled by dovish Central Banks (CB). Aware investors should recognise that the late cycle phase and mature market trends require improving fundamentals and positive political events to deliver sustainable uptrends in risk assets. But, it is difficult to see such improvements happening in the short term. Purchasing Manager Indices have been declining and what we are seeing is a deterioration in the 'quality' of growth. Headline figures of growth are still moderately positive, and not far off our expectations of few months ago, but the composition of growth has changed. Most components of growth are of concern to policy makers beyond the decline in trade growth. We particularly pay attention to the decline in investment growth. However, as far as domestic demand is concerned, it remains healthy, thanks to sound labour markets.

Can this equilibrium hold, given the fragilities overall have increased?

In our view, risk assets will continue to face significant hurdles, with sharp selloffs occurring due to data being below expectations, disappointments related to trade negotiations, and repricing of expectations based on changes in CB policies, which will continue to trigger volatility. In this situation, **the behaviour of CB becomes crucial again**: markets all over the world are currently pricing in rate cuts, with more than 100 bps expected in the US before the end of 2020 and lower rates also likely in Europe, Japan, Canada, Australia and New Zealand. **Promises of interest rate cuts and easier financial conditions will likely keep the Goldilocks narrative alive** and help markets to avoid persistent downturns in stock prices. However, **there are still risks of policy mistakes being made by CB**: the line between 'pre-emptive' or 'reactive' CB cuts is very thin. While a pre-emptive Fed will likely be market-friendly for equities, a Fed perceived as reactive, or as starting an aggressive easing cycle, would probably be of concern to investors, as they would start to read higher recession risks in the numbers.

Can we expect there to be any positive developments on this journey?

If our central case is confirmed, the Fed could deliver a pre-emptive cut this year, responding to risk assets' appetite for liquidity. With lower rates in the US, China could have more space for monetary policy easing. A stabilisation of growth could be possible. Countries in Europe with fiscal space could experience a fiscal boost thus sustaining internal demand. Regarding the US, this will be more of a story post-2020 election. The markets would make a toast if a deal between China and the US is reached, which could happen in the medium term, even if tensions between the two countries continue related to a much deeper and long term geopolitical strategic game.

Setting the unpredictable aside, we focus on what is reasonably predictable – ie, **a further extension of this extra-long cycle** – and we build our investment strategies around the following convictions:

- **A positive stance on credit and spread products**. Search for yield is definitely in focus, thanks to the refreshed CB dovishness. We keep a cautious and flexible approach to avoid areas of fragility;
- **A constructive stance on EM Bonds**. EM continue to be supported by the Fed dovishness and expected USD weakening. Here the **focus on vulnerability** (investing in the less fragile countries) will be key at this point of the cycle as weaker demand from DM tends could affect some EM;
- **A moderate defensive stance on equities.** Lacking strong fundamental support, we prefer to play the Goldilocks scenario via credit. That said, the **European equity market seems to have already priced in the worst case scenario**. Valuations are attractive and positive surprises could support the asset class on a relative basis;
- **The FX market as a liquid instrument to play trade disputes** and political uncertainty.

There is not much room to make mistakes in this sort of market: potential gains and losses show an asymmetric profile. We recommend keeping a cautious risk stance. We think it is key to protect YTD gains (which are not far off our goals of the beginning of the year), as we are well aware of an overall increase in fragilities.

Overall risk sentiment

Overall a still cautious approach, with some opportunities on risk assets.

Changes vs previous month

- More positive on Euro IG Credit and EM Bonds (tactically also in local currencies), and cautious on US corporate credit
- More constructive on EU equities

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

MACRO

Central banks: seeking to extend the cycle

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

The ECB and the Fed delivered the same message: they are ready to act "if necessary". Their tones contrast with the current economic conditions. Domestic demand on both sides of the Atlantic remains resilient, particularly household consumption, which still benefits from good labour market performances. True, the manufacturing sector and global trade are both at half-mast and business investment is expected to slow in the US. And we have been observing for a few years that the correlation between industry and services tends to diminish. That said, more pressure on the manufacturing sector implies higher risk that weakness will spread to the economy as a whole. This is CB's fear today, in addition to inflation, which is too low at this stage of the cycle.

> **"The ECB and the Fed delivered the same message: they are ready to act "if necessary."**

The ECB has revised its economic forecasts, but at the margin. The stronger-than-expected growth in Q1 gave the bank the opportunity to raise its figures for the Eurozone in 2019 (from 1.1% to 1.2%); on the other hand, it revised its forecast for 2020 down (from 1.6% to 1.4%). The ECB is concerned about the weakening of inflation expectations. Companies do not have enough pricing power to pass on wage increases in selling prices. **The combination of subdued growth, falling inflation expectations and increased downside risks explains the ECB's tone.** Opening the door to a rate cut is intended to prevent the euro from appreciating "by default" (if the Fed were to lower its key rates sooner than expected). Opening the door to a new securities purchase program is intended to maintain very accommodative credit conditions. Finally, the generous terms of the TLTRO-IIIs are intended to guarantee the banks cheap funding for an extended period of time.

On the Fed side, the bias has clearly become accommodative with the disappearance of the term "patience" in the bank's statement of 19 June. The economic outlook – even if business investment is expected to slow further – does not fully justify the rate cuts that are priced in by markets. And, Chairman Powell was very careful not to feed such expectations. **But a possible increase in protectionist tensions between the US and China is being taken very seriously by both the Fed and the ECB.** The Eurozone is about twice as sensitive to world trade as the US. A fall in global demand can therefore be accompanied by unwelcome disinflationary pressures if the euro appreciates at the same time. The ECB is now expected to clarify its intentions and forward guidance at its next Monetary Policy Committee meeting (25 July). The next FOMC (31 July) could also be an opportunity to give some more clues regarding Fed's policy. Finally, while trade-related risks are explicitly mentioned by the ECB and the Fed, **both CBs fail to highlight what growth owes to the increase in public and private debt.**

To ensure the solvency of indebted agents, there is nothing like keeping interest rates artificially low (i.e. well below nominal GDP growth) – in addition to the fact that by containing the debt burden, monetary policy opens up opportunities for a complementary fiscal stabilisation, if needed.

DM = Developed Markets, EM = Emerging Markets, CB = Central Bank, ECB = European Central Bank, Fed = Federal Reserve. ERP = Equity risk premium is the excess of return of equity investing vs. risk free rate. TLTRO: The targeted longer-term refinancing operations (TLTROs) are Euro system operations that provide financing to credit institutions for a predefined period of time.

The Strategist's view

The markets conundrum

Fixed income market: Trump trade unwound

The fixed income market has now priced out all the reflating effect previously attached to the Trump fiscal reform In the US: inflation expectations are now back to pre-Trump levels. The US 30Y yield is also at levels similar to those prior the US Presidential elections while the US 10Y yield is still slightly higher. What is very different vs 2016 is the shape of the US curve, which is now much flatter (and negatively inverted in the short end), with the Fed having normalised interest rates. As growth uncertainty and tariff disputes increased in the past months, markets aggressively priced in the beginning of a tightening cycle, causing the forward curve to bull steepen.

Is the weakness in PMIs priced in by the markets?

The May equity market correction, which followed, among other factors, the deterioration of PMIs, was deep, and shifted the equity risk premium down to levels below trend, creating room for a short-term rebound. Is the rebound sustainable, considering the current decline of PMIs? Looking at PMI levels, we see limited room for further upside of the stock market. To assess the impact of PMIs on financial markets, we identified different regimes of PMIs. The current regime (US manufacturing PMI in the range 50-53) is historically associated with EPS growth of around 3%, much lower than analysts' expectations of roughly 10% discounted in today's equity prices. A narrower discrepancy from what is discounted and what is "PMI-consistent" emerges in the interest rates market: the current PMI regime would call for rate cuts not far from what short rates are discounting.

MULTI-ASSET

Time to play central banks and politics

MATTEO GERMANO, Head of Multi-Asset

We still call for a late cycle environment with extra dovish central banks. Growth concerns and trade disputes continue to be the key risks which darken the outlook. On trade in particular, although we still expect a deal between US and China will be eventually reached later in the year, we do not expect any near-term solution. Uncertainty may remain high with regards to geopolitical risks.

High conviction ideas

Given this backdrop, we maintain a **defensive stance on equities,** as the risks of negative EPS revisions remain high and we prefer to seek value by playing key themes, such as: divergences in growth and central banks policies, and politics- related topics.

In fixed income, the Goldilocks scenario induced by accommodative CBs remains our central case, and we do not expect recessions in the coming months. Therefore, we believe that the "hunt for yield" theme remains front and centre. Hence, **we increase our preference for corporate bonds – in particular in the investment grade space** – which is backed by strong technical factors and the low rates environment. Here, we **prefer Euro corporates to US,** due to better fundamentals and favourable technical trends against expensive USD hedging costs.

> "ECB dovishness make Euro IG credit even more appealing."

On rates, we revised our forecasts down, and keep our preference for 5Y US vs 5Y Germany; we also remain negative on the German short end (2Y), where we don't see any value left. In the UK, the weaker outlook for growth, combined with nominal rate vulnerabilities to sharp sell-off, supports our defensive stance on UK real rates (10Y). In Norway, a strong domestic economy is still supporting the central bank's hawkish stance, compared to a more dovish stance from the ECB, which is still facing downside economic risks.

Thus, we continue to prefer the NOK vs the EUR. In playing **relative value opportunities,** we prefer the Italy-Germany 10Y spread versus the 2Y spread, as we believe it offers more interesting carry and has more potential for tightening.

A political theme we are currently playing is the possibility that Trump could withdraw from NAFTA by presidential notice. This could increase pressure on the Democrats on one side and on Mexico on the other. We express this trade risk theme via currencies with a positive view for USD vs CAD. We do not expect the ratification process to be completely derailed, but we would like to be protected if the negative scenario materialises.

EM markets in general continue to remain an area of interest, especially as the threat from US rates and a stronger dollar dissipates. In GEM equities, we have a neutral stance overall, but we maintain regional preferences, such as Korea and China, which could benefit if visibility around trade negotiations improves or as a domestic demand story. On EM Bonds, with an income focus, we continue to **seek selective opportunities, favouring hard currency to local currency**. On the GEM currency space, we have a preference for IDR, BRL, RUB vs ZAR.

Risks and hedging

The market continues to be focused on the risks of a trade war (US vs China, but also vs the Eurozone, Mexico, Canada) and other geopolitical issues (tense situation in the Gulf of Oman) and their impact on the growth outlook. We suggest maintaining some hedges through a preference for the Yen vs USD, which should outperform in case of a further escalation in geopolitical risks..

GEM = Global Emerging Markets

BRL = Brazil Real, CAD = Canadian Dollar, EUR = Euro, IDR = Indonesian Rupiah, NOK = Norwegian Krone, RUB = Russian Ruble, USD = US Dollar, ZAR = South African Rand

Amundi Cross Asset Convictions

	1 month change	---	--	-	0	+	++	+++
Equities			■					
Credit	↗							■
Duration					■			
Oil					■			
Gold					■			
Euro cash				■				
USD cash						■		

The table 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

Expect rates swings on monetary policy uncertainty

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

We see two key themes driving fixed income markets: **1. The potential impacts of a trade war on growth prospects and 2. The Fed's and the ECB future dovish policy stances.** The two themes are strictly interconnected as they drive market expectations on CB policy moves, with CB on their side watching out for growth evolution and financial conditions to reassess their policy mixes.

The implications appear to be a strong push on yields towards record-low levels, with markets in our view too complacent on future FED cuts and a continuation of a more volatile regime on bond markets. It is paramount to be ready to tactically **adjust duration views, play curve opportunities and seek carry** with a selective approach to avoid areas of complacency and poor fundamentals or unrewarded liquidity risks.

> “Markets have gone too far in pricing in aggressive Fed cuts. This increases the risk of disappointment.”

DM bonds

We expect US Treasury rates to stay supported, due to the increased downside risks to growth and the low visibility on trade issues which, in our view, encourage a prudent approach. **We see some value in TIPS**. Despite the recent weakness in inflation data, an escalation of tariffs will tend to boost near-term inflation, a concept that is currently completely off investors' radars: market measures of inflations expectations (eg, inflation breakeven) are at extreme lows.

In Europe, from a relative value perspective, **we maintain a positive view on the main peripheral European countries,** preferring Spain to Italy based on higher political risk and potential warnings on the budget deficit (though 30Y Italy could be an interesting area to monitor). We see opportunities on the Euro curve (e.g., playing a flattening move on 5-30Y segment).

Credit

Credit is well remunerated on the basis of current outlook, but we recommend a selective approach, with a preference for the short end of the credit curve and **favouring Euro IG**. In the US, given the increased risks, we continue to r**ecommend a 'careful carry' posture** that involves reducing overall risk and moving up in quality. Within government-quality sectors, we view **Agency MBS** as especially attractive relative to nominal Treasuries. We continue to play the strong fundamentals of the consumer sector within the **structured securities'** space.

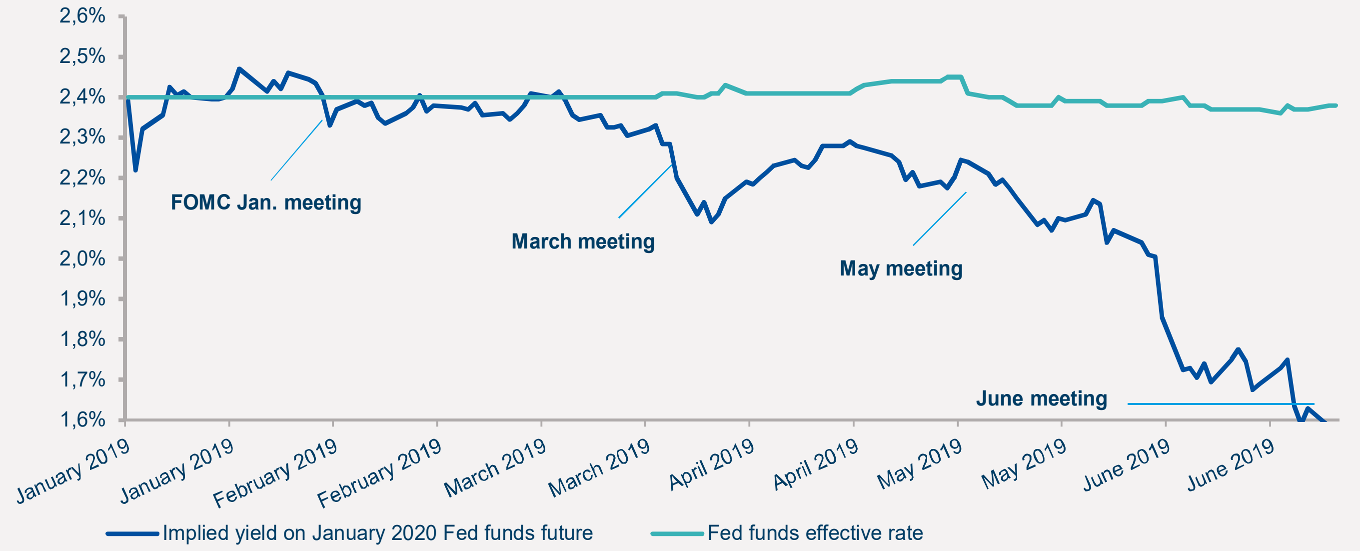
EM bonds

Despite recent trade tensions, performances for both EM local and external debt were positive, benefitting from a tightening in spreads. Potential FED cuts this year and the lower-for-longer yields in DM should favour EM assets. **We like EM local duration** (Brazil, Indonesia, Russia and South Africa) **as we think that EM rates can perform well in different macro scenarios** due to anchored inflation expectations**.** We are **still cautious within EM LC,** especially in low-yielding, China-sensitive economies in Asia, but **our outlook has tactically improved**, given a stable US dollar.

FX

The **USD** remains one of the highest yielding among the main DM currencies and could offer some protection against trade escalation. We **stay cautious on the Euro**. On EM, we favour some Eastern European and LATAM currencies (BRL and RBL), while staying cautious on Asian ones (KRW, TWD, SGD) more vulnerable to protectionism.

Markets price Fed rate cuts



Source: Amundi analysis on Bloomberg data. Data as of 20 June 2019.

EQUITY

Play quality cyclicals, stay away from “bond-proxies”

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

Overall assessment

The equity rally was capped early in May on renewed concerns about US tariffs, but after the pullback, the equity market quickly recovered, staying close to all-time highs. What is peculiar regarding this market is that flows have not accompanied the rally of the first months of 2019, and this is especially true for DM equities. In an environment of low rates and a prolonged long cycle, with deteriorated but stabilising macro fundamentals, we believe that equities could continue to be supported, based on interesting valuations (in some segments), low investor positioning, and potentially supportive factors further extending the cycle (dovish monetary policy and areas of supportive fiscal stance in Europe). Nevertheless, with uncertainty still high, the market will continue to be vulnerable. Volatility and valuation dispersion could offer opportunities for active stock picking.

DM equities

European markets look more attractive vs the US based on valuations: the Brexit saga, Italian political situation, exposure to trade issues, and low growth have contributed to Europe being unloved. This perception could change with a Brexit deal and with some improvement on the US-China trade front. We don't foresee earnings growth driving European equities from here into the next year. Earnings growth is probably set to continue to be revised downward, although not equally across sectors and names. This environment plays well for selecting opportunities among and within sectors. Overall, **we prefer cyclicals vs more defensive segments,** which, in our view, have become too expensive. **We like high-quality industrials with strong balance sheets,** some of which discount very negative outlooks, and we see opportunities in healthcare as well. We find tactical opportunities selectively within European banks which on the whole are trading at extremely depressed valuations. The negative story on European banks is well known, but implied expectations are too low in some of the higher-quality core European banks.

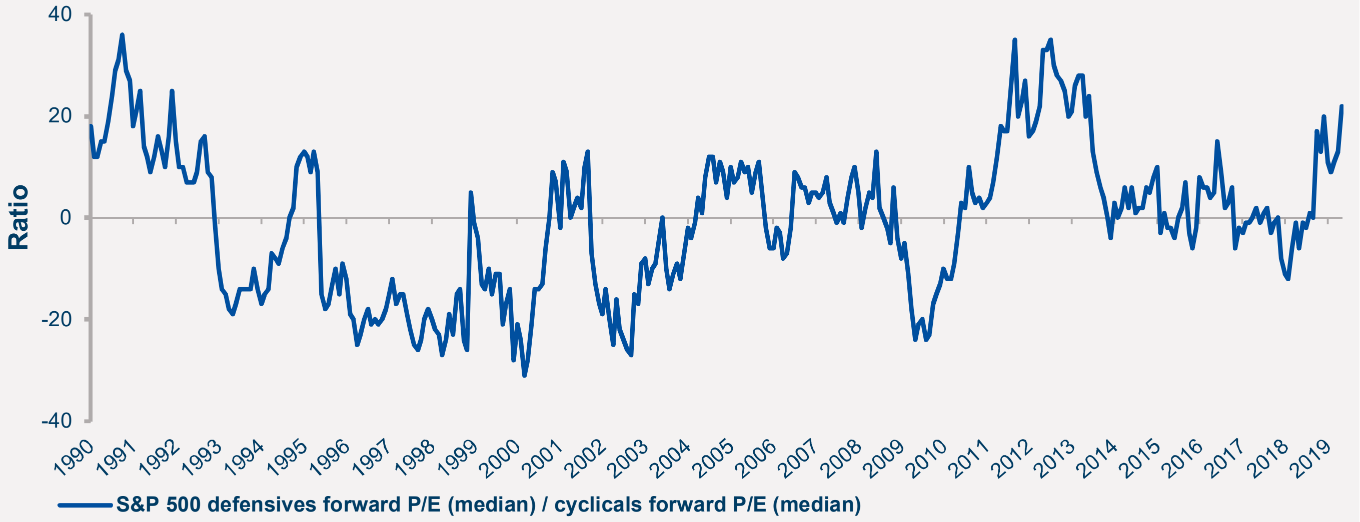
In the US, the value segment is at the cheapest levels since the tech bubble and the financial crisis. In order to have a strong performance of the value sector, we need reflationary conditions which are not visible in the current phase of the cycle. But the heavy short positioning and the extreme valuations suggest a **preference for at least some segments of the value space,** in particular: **quality cyclicals** with long-term growth characteristics, but priced for a recession; retailers relatively insulated from pressure from online sellers; **mega cap banks** that have been regulated into stability and that have the scale and technology to win. Among our strongest convictions, we believe that **"bond proxies" stocks are extremely overvalued** (e.g. some consumer staples and utilities stocks).

> "In the search for yield, some bond proxy stocks have become too expensive on both sides of the ocean. Despite cheap valuations, value sectors are not a buy per se, but a selective play."

EM equities

At this juncture, we think the US-China trade issue remains the main trigger that could either boost or negatively affect the asset class. Despite a still-constructive outlook for EM equity supported by our expectation for a deal to be finally reached (at least partially) and earnings stabilisation, we expect short-term volatility. Therefore, we have turned slightly more defensive on China for the time being. We focus on markets where valuations look set to remain supportive and where idiosyncratic risk is less pronounced, and avoid sectors most exposed to possible tariffs.

Defensive stocks reaching extreme valuations



Source: Amundi, Bloomberg. Data as of 18 June 2019.

Amundi asset class views

	Asset Class	View	1M change	Rationale
EQUITY PLATFORM	**US**	-/=		The extension of the bull market counts more and more on the Fed initiating an easing cycle. Earnings downgrades have no reason to stop in-between times, in line with some global growth moderation. So the outlook for the market is broadly unchanged. Opportunities are at the sector/ stock levels as risks are still broadly asymmetric.
	Europe	=/+	▲	Some arguments for a more positive relative call on European equities are related to a stabilisation in the economic outlook and reduced political risks, converging earnings growth with the rest of the world and attractive valuations on a relative basis. Investors could continue to benefit from strong sector rotation and high valuations dispersion.
	Japan	-/=		Broadly unchanged outlook. The earnings per share momentum is weak, although valuations are very attractive. Increased volatility due to geopolitical factors, could lead to a stronger Yen, which could potentially be a drag for the market. Opportunities could be found at the stock picking level, but we are cautious on the overall market.
	Emerging markets	=/+		We have a slightly positive view on EM equities on the back of a stabilising earnings outlook. We prefer domestic demand stories, which look more resilient in case of a continuation of trade disputes.
FIXED INCOME	**US govies**	=		Markets have gone too far, in our view, in discounting aggressive Fed cuts and the risk of disappointment and volatility have increased, due to current economic and financial conditions. We have a neutral view on duration.
	US IG Corporate	-/=	▼	We have a cautious view on credit markets, as there are segments, such as the BBB, that could be affected by some downgrades. Investors should continue to favour a "careful carry" posture that involves selectively reducing credit risk and moving up in quality. We prefer securitised credit to the corporate sector, as the US consumer sector is strong.
	US HY Corporate	=		Our outlook for the asset class is broadly unchanged. We see valuable carry, but limited space for spread compression The still sound economic picture is benign for the default outlook. Default rates are expected to remain very low in 2019.
	European govies	-/=		The new dovish ECB stance will prevent any rise in core yields. The market is expensive and it will remain quite expensive as the search for safety will continue to be at the forefront of investors' minds. Opportunities can be found playing yield curve flattening and Euro peripheral bonds - for example, in the very long end of the curve where 30Y maturities could bring significant carry in the government space.
	Euro IG Corporate	++	▲	We have recently upgraded our view on the asset class. The dovish tone of the ECB and the recent spread widening amid stable fundamentals are supportive factors for the asset class, which could enjoy mild spread compression and investors' appetite in the search for income.

Amundi asset class views

	Asset Class	View	1M change	Rationale
FIXED INCOME PLATFORM	**Euro HY Corporate**	+		The high yield segment, as well as the IG, could enjoy the dovish ECB tone and benefit for a mild spread tightening. 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 selective carry opportunities.
	EM Bonds HC	=/+		Our view is still constructive on HC debt. Financial environment is supportive for EM duration (attractive carry, pretty low and stable US rates, stable US Dollar, dovish Fed and dovish EM Central Banks, and subdued inflation).
	EM Bonds LC	=/+	▲	The accommodative monetary policy stance, we believe, will be able to offset the hurdles to global growth from protectionism. Therefore, we have tactically improved our outlook on the asset class.
OTHER	**Commodities**			Oil price rebounded on tensions between Iran and the US, after having plummeted in May as trade war escalation added concerns to economic growth. Recent US inventories figures, which were higher than consensus, added pressure, despite the overall central case still being supportive for commodities. For WTI, we keep the US$55-65 range as OPEC will remain vigilant and committed to stabilising prices. Base metals will be affected by China and global economic slowdown.
	Currencies			EUR/USD: the single currency is still trading in a tight range as both the Fed and the ECB turned more dovish. We expect the EUR/USD to trade around 1.17 on a 12M horizon while remaining supported in the short term, due to political and growth concerns in Europe. We expect the USD/JPY at 107 on a 12M horizon. EM FX are expected to appreciate from current levels (+1.2%), according to models. Being selective remains key.

LEGEND

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	Negative		Neutral		Positive		Downgrade vs previous month	Upgraded vs previous month

Source: Amundi, as of 24 June 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

Italy: a long and winding road

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Finalised on 02/7/2019

The essential

Arm-wrestling within the Italian government and between Italy and Brussels to find a solution to the Italian budget and avoid the Excessive Deficit Procedure.

After Italy's exit from a technical recession in H2 2018, economic data are still pointing to weakness, and many risks loom in the second half of this year. Weak growth prospects are making it more difficult to comply with deficit and debt targets, although some savings may come from lower spending. In any case, the 2020 budget is the most challenging test for the government.

Besides the persistent challenges we just referred to, short-term technicals and relative value look favourable to Italian debt. H1 2019, in fact, closed with promising achievements in debt refunding activity conducted by the Italian Treasury, thanks as well to the return of foreign investors, while the H2 demand-supply balance looks to be supported by higher volumes of redemptions. Relative value has favoured recent spread tightening and yield hunting in the European "desert of yield" is likely to remain, as the ECB has become more dovish.

Italy retakes centre stage in Europe

The Italian government and the European Commission are once again at loggerheads after Brussels affirmed that, based on their assessment, an excessive deficit procedure against Italy is warranted for violation of the debt rule in 2018.

EDP and the critical 2020 Budget Law

As we write, the procedure is in its early stages and, in theory, could still be averted, as it would require approval at next ECOFIN meeting (scheduled for 9 July). Recent press articles[1] have even suggested that the European Commission may not trigger an EDP, raising hopes that the Italian government could revise its spending plans and avoid a clash with the EU.

Negotiations are reportedly progressing between the Italian Government and the EU Commission on the basis of updated projections by the Italian ministry, which may show a better-than-expected outcome in terms of deficits for 2019 and 2020. This would be due both to higher revenues (owing to the tax amnesty scheme and to higher dividends from controlled companies) and to lower expenditures (due to a lower take-up rate for early retirement scheme and the citizenship income package).

As we write, the Italian Government approved two different measures able to bring the deficit projection for 2019 back to the 2.0% level agreed with the European Commission back in December 2018: the combined effects from the budget adjustment law and the law decree would save €7.6 bn, compared to April deficit projections and represent an important move from the Italian Government to get to a compromise with the EU Commission.

As a result, the EU Commission on the 3rd of July decided not to recommend to the Ecofin to start the EDP against Italy, as the three conditions to avoid it were met: to compensate the 2018 realised deviation, to correct the 2019 expected deviation and to have some commitments about 2020 budget.

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[1] *Brussels to pause budget sanctions on Italy, Financial Times, 24/06/2019*

Economic background

From an economic point of view, the Italian economy likely faced a weak spot in 2019H1. After exiting from a technical recession in 2018 H2 by posting a meagre 0.1% QoQ growth in the first quarter of 2019, the second quarter is posed to be weak. Coincident indicators monitored by the Bank of Italy and the National Statistical Bureau (ISTAT) all point to stagnating activity between April and June. For the second half of the year, official projections expect a normalisation to somewhat higher quarterly growth on the basis of a modest recovery in export-led demand.

Our forecasts for the Italian economy are for average annual growth of 0.1% YoY in 2019, followed by 0.5% in 2020. Key drivers to our call are decent growth in domestic demand, albeit characterised by a weak performance from investments and capex, and a pickup in external demand from H2.

On the domestic side, personal consumption is getting some support from still-resilient consumer confidence, especially in the personal assessment component, although optimism about the overall economy has been deteriorating somewhat. Household spending for final consumption has been holding up recently, notwithstanding a deceleration in disposable income and purchasing power, thanks to a decline in the savings rate. Recent measures for increasing disposable income among lower-income persons may have some limited impact on supporting consumption, but the Italian government itself does not consider these measures to be a game changer this year. On the investments side, business confidence has been declining over the past 12 months, likely due to a combination of domestic and external factors in both the manufacturing and service sectors. However, some signs of recovery have shown up recently in surveys. Yet, on a net basis, firms reportedly are reluctant to invest and access to credit appear to be somewhat more difficult.

Inflation is broadly expected to remain muted, in the 1% range, as unemployment remains relatively high and wage and salary dynamics subdued, albeit supported in 2018 by a raise in public employees' wages.

Projected fiscal patterns

In this macroeconomic context, the governments' growth targets (as per April projections) are not far from the consensus in 2019-2020, yet major concerns remain on its ability to maintain the debt/GDP ratio on a downward path due to risks of fiscal slippage and lower inflation. The key to the projections is indeed the VAT rate hike (approx. €23bn) expected to take place under current law in 2020. On the one hand, it would limit the deficit expansion, but, on the other, it would have a temporary effect in lifting the GDP deflator, thus lowering the debt /GDP ratio from the expected 132.6% of 2019 to 131.3% in 2020. Yet, the government appears to be quite vocal in signalling that this VAT increase would not take place.

As a reference, the EU Commission's projections, which do not reflect this VAT hike, project the debt/GDP ratio to move from 133.7% in 2019 to 135.2% in 2020. Together with the high debt level, of particular concern to the debt sustainability projections is the expected path of the primary balance, which, over the government's forecast horizon, remains well below the levels that would be required to put debt/GDP on a stable downward path, in the context of the current macroeconomic projections and high interest expenses (3.6% of GDP in 2019-2020).

Italian debt: supportive technicals and attractive relative value driving Italian spreads

Technicals

H1-09 saw promising trends in Italy's refunding…

By the end of June roughly 60% of yearly scheduled new issuance of medium- and long-term Italian debt is likely to be completed by the Italian Treasury, with a high average maturity close to 10 years. Just to summarize the main numbers and facts of H1 trends in this respect:

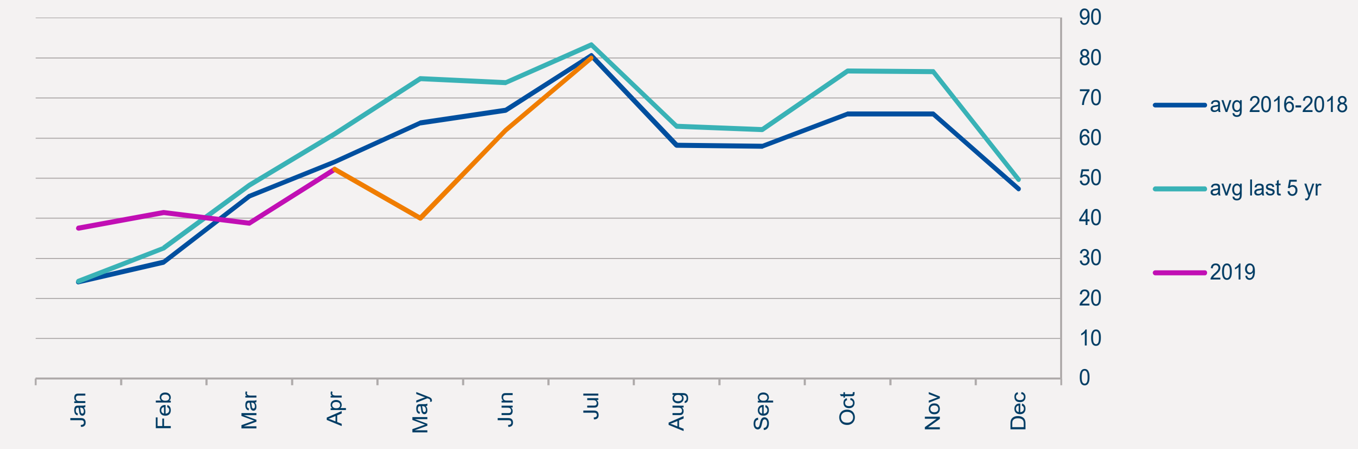
- Italy issued almost €150 bn in new medium long term debt, or 60% of the estimated €250bn overall issuance expected in 2019;
- Net issuance totalled €62 bn, more than the €50 bn projected yearly net issuance;
- Following very long deals in January and February on 15yr and 30yr maturities, the Treasury placed a 20yr BTP in June, keeping the average maturity of new debt close to 10 years, higher than the 6.8-yr average maturity in overall debt stock;
- Year-to-date extra-long debt represents 25% of total issuance, well above the 14% of the same period of 2018. The Italian Treasury is probably close to its targeted volumes in the 15yr area and close to 70% of targeted issuance in the 30yr;
- The demand side had recorded the return in size of foreign investors in Q1 (by roughly €20 bn), which in turn supported strong supply-side activity by the Italian Treasury. Investor demand generally still looks supportive, being sustained by recent market trends and new dovish messages from the ECB. The new 20-yr bond issued in June collected a book of €24 bn, four times the final amount issued. Both geographical and investor type

breakdown showed that the search for yield is mainly from Europe (core and UK) and from asset managers and banks, with foreign investors making up almost two thirds of the demand. Overall, these details seem to confirm that non-domestic institutional investors keep reversing 2018 negative flows.

... and H2 demand-supply balance looks supported by higher volumes of redemptions

- Heavy issuance of extra-long bonds represents the main difference with respect to previous years: long duration of issued debt means that Italy now has a buffer of flexibility in managing next months' auctions, which are likely to focus more on 2-3 yr and 10 yr, in order to reduce pressure on the 5-7 yr section.
- This will provide the Treasury with more flexibility in managing the duration of coming auctions, which may turn out to be more short-term-oriented, in case of volatility and higher risk aversion in H2.
- H1 2019 recorded roughly €85 bn of redemptions, around 40% of overall yearly overall flows.
- H2 2019 therefore looks supported by high volumes of redemptions, as July will be the last month of the year with almost flat volumes of maturing bonds. September and October, on the contrary, will respectively record €43bn and €26 bn of redemptions.
- Cumulated net issuance is therefore likely to grow further and to peak by the end of July, then to fall in the following months. According to our estimates, net issuance is likely to peak in July, close to previous years peaks, in the €75/80 bn region and then to fall vs 50 bn by year end.
- The seasonality of net issuance is quite evident from the reported chart and we outline a few points here:
  1. H1 always shows quite a rise in net issuance to levels close to each year's peak, and then in H2 net issuance tended to fall (this is true considering last three and give years, together with the 2019 trend);
  2. In H2, net issuance always tends to be quite negative in August and December,
  3. September is likely to take August's place this year, with a sharp fall of cumulated yearly issuance.

1/ **Italian sovereign bonds: cumulated net issuance, in EUR bn**



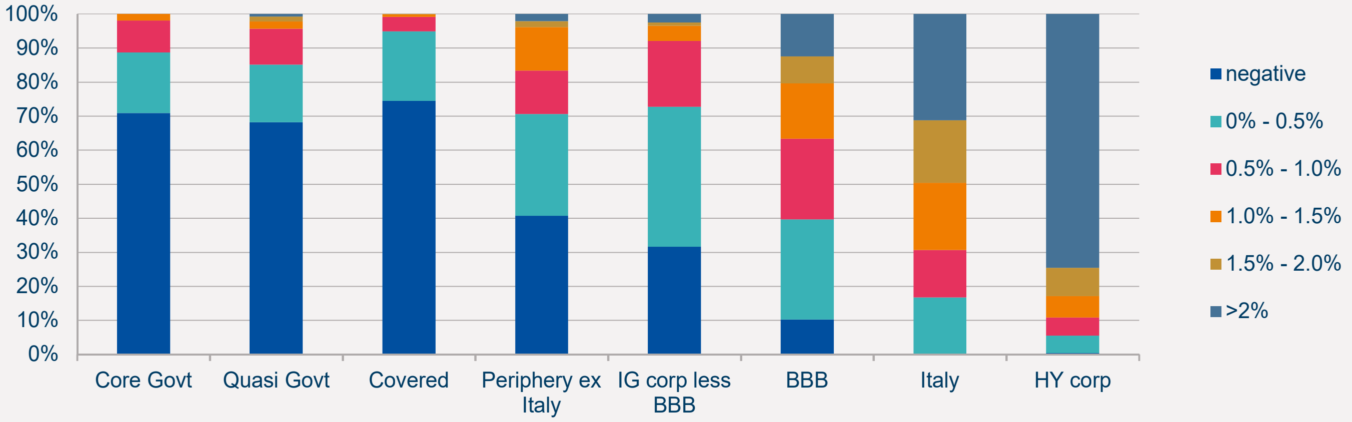
Source: Bank of Italy, Amundi Research, data as of 28 June 2019

Relative value has favoured recent spread tightening: yield hunting is here to stay

On the back of the substantial change in the ECB's monetary policy stance and recent dovish messages from Draghi, together with the sudden revisions in market implied US rates, EUR-denominated bond yields felt much more the "gravity force" from central banks or rate expectations. Among other results, this has meant that most core countries' curves have slipped into negative territory in maturities up to 10 yr, along with a comparable dramatic shift down of other segments, like quasi-government, agency and covered bonds. The desert of yield recently entered uncharted territory in the Eurozone. This is summarized by the reported chart 2), which, for each asset class belonging to EUR fixed income, shows the distribution of debt by yield bucket, from negative to above 2%, as of early June. In order to better develop the analysis, we break down periphery government bonds into two segments: Italy and the rest of periphery, while among corporate bonds we differentiated between BBB-rated and higher rated IG bonds (namely AAA-AA and A-rated). Interestingly, Italy shows a mix of offered yields between BBB corporates and HY debt. Valuations are more attractive also on a volatility-adjusted basis, as spreads remain more in range in the past few months.

As anticipated, chart 2) represents, for each asset class belonging to EUR fixed income, the distribution of debt by yield bucket, from negative to above 2%: Italy shows a mix between BBB corporate and HY debt. Most core govie, quasi-govie and covered bond debt is in negative or flat territory.

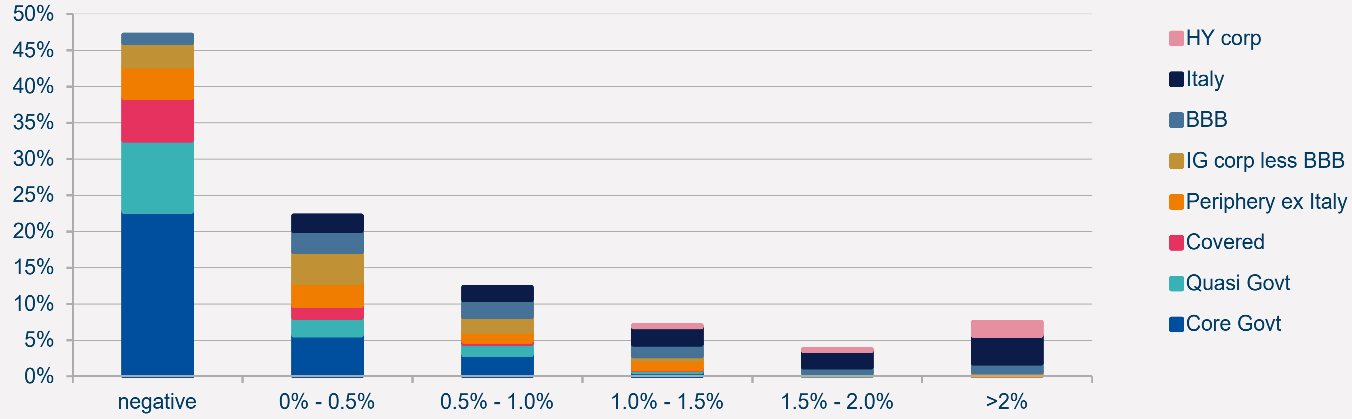
2/ **EUR fixed income debt: distribution by yield bucket for each asset class, as of June 28th**



Source: Bloomberg, Amundi Research, data as of 28 June 2019

Where are positive yields available? The following chart 3) shows it, considering the entire market: just 11% of overall EUR denominated debt offer an yield above 1.5%, mostly by Italy and HY segment. Debt with negative yield reached 47% of the total, debt with an yield close to zero reached 22%.

3/**EUR fixed income debt: distribution by yield buckets of the entire market, as of June 28th**



Source: Bloomberg, Amundi Research, data as of 28 June 2019

A few considerations are important, in our view, in analysing the picture offered by fixed income market

- Most core government bonds, quasi-government bonds and covered bond debt is in negative or flat yield territory: the debt belonging to these "safe" haven segments together accounts for 55% of overall available debt in the EUR fixed income market.
- Moving on to periphery debt, if Italy is excluded, the situation doesn't significantly improve, as this segment represents 11% of EUR fixed-income debt, but offers only 8% of the still available positive yield, a very similar mix of IG excluded BBBs (respectively at 10% and 8%).
- This leaves us with the last three segments: BBB corporates, Italian debt and HY debt, which together make up just a quarter of the market "benchmark" but cumulate around 70% of yield left.
- If we focus on debt yielding more than 1.5%, most of the available debt is represented by Italy and HY.
- If HY bonds are excluded from the computation, for example for rating constraints limited to IG, the dominant role of Italy rises to 40% of the remaining overall yield available.

The return by the end of June of 10-yr spreads in the lower levels of last month's range trading, despite renewed uncertainties about a possible EDP and a persistent weak macro picture shows to what extent technicals are prevailing over other factors in this new phase of lower rates for longer and risks of more QE. The subsequent, sharp fall of BTP spread to the 200 bp area, as we are writing, was also supported by the favourable decision of the EU Commission not to trigger the EDP. In a nutshell, technicals and valuations are likely to continue partially balancing political uncertainties and weak growth.

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** | **25%** probability | **No-deal Brexit**

Analysis | Following PM May's failure to obtain parliamentary ratification of the Brexit Withdrawal Agreement and her resignation as head of the Conservative Party, the UK is in the midst of a deep political crisis. Members of the Conservative party now have to choose between the two candidates, Boris Johnson and Jeremy Hunt, that Conservative MPs have shortlisted to become party head and therefore PM. Both say that, while they would prefer to renegotiate the Withdrawal Agreement with the EU (something that the EU says it will not do), they will go for a no-deal Brexit on October 31 if renegotiation proves impossible. While this risk of no-deal is very real, the future PM will also face an unchanged parliament that remains opposed to such an outcome. The capacity of parliament to block no-deal (which is the default legal solution) is unclear but another possibility could be a no-confidence vote, which would lead to new elections. Another extension of the Art. 50 deadline cannot be ruled out: although this would require unanimous approval from EU member countries (with some currently very reluctant), it could become necessary in case of new UK elections or if the UK opts for a new referendum. Finally, the UK also has the possibility to revoke Art. 50 unilaterally. There are therefore still many possible outcomes (deal, no-deal, new delay, elections, Art. 50 revocation…) and political stress will be very high after the summer recess. The European election has shown how polarised the country is (hard Brexit parties scored well, but so did staunchly Bremain parties). The only good news is that fewer and fewer protesting/populist parties in Europe are calling for exit from the Eurozone (which would require an exit from the EU). It is likely that they are being vaccinated by the British turmoil.

Market impact | In the short run, uncertainty is likely to stay elevated as long as the new Prime Minister is not designated and it may even rise further when the next government adopts a confrontational approach with the EU-27. -In the face of uncertainty, the risk premium on UK assets must be sufficient - with a weak currency and lower prices for risky assets - to attract foreign investors. Is this enough today? Nothing is less sure! 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 or the article 50 be revoked, we would see the opposite, The situation remains very binary and thus not very conducive to strong portfolio recommendations.

Risk # **2** | **25%** probability | **Political instability in Italy with renewed stress on BTP**

Analysis | Due to the breach of the Debt rule in 2018, the EU Commission considers that an Excessive Deficit Procedure is warranted for Italy. More worryingly, official estimates project the Debt to GDP ratio to increase from 132.2% in 2018 to 132.6% in 2019, before declining to 128.9% in 2022. The Italian government is reportedly negotiating and working hard to find not only additional resources for 2019 to compensate for the past breach, but also to address the most challenging task, which is the 2020 budget. Although political incentives may not be absolutely in favour of this outcome, we cannot completely rule out the possibility of a government crisis and snap elections, the earliest date possible being September (although this could fall very close to the start of the 2020 budget discussion).

Market impact | Notwithstanding the better-than-expected Q1 GDP, which marked an exit from the technical recession seen in the Italian economy in H2 2018, the markets remain nervous about the Italian government's new confrontational tones with regard to EU budget rules. Moreover, heightened tensions within the government coalition have increased the risk of snap elections and the uncertainty about how

Italy will deal with the daunting task of addressing the 2020 budget, which should eliminate relevant VAT hikes while revamping a challenging spending review. At the moment, there is no systemic risk in our opinion. We perceive the risks as remaining domestic. Keep in mind that the ECB has anti-contagion tools that it can call on to avoid a spread to other peripheral markets. In addition, the ECB has announced new TLTROs to alleviate the banking system. All of this should contain the contagion risk on peripheral sovereign spreads and on corporate credit spreads.

Risk # **3** | **20%** probability | Major European slowdown

Analysis | After Q1 GDP growth figures (+0.4% QoQ for the entire Eurozone), which came as a relief but were partly due to positive temporary factors (strong precautionary imports from the UK and mild weather which supported construction), Q2 indicators showed much more moderate growth. Moreover, manufacturing surveys have stabilised, but have barely improved from the low levels reached after a series of domestic and external shocks in recent quarters (specific sectoral issues in the car industry and rising US-China tensions). Should they remain depressed for long, more contagion to the rest of the economy will occur. A number of risks could worsen the situation after the summer, notably an escalation in US-China tensions (to which European manufacturing is heavily exposed through global value chains), US tariffs on the European auto sector (a decision could come in November), a no-deal Brexit (at the end of October) or a worsening of the political crisis between Italy and the rest of the EU. Such problematic events could occur against a backdrop where the key supporting factors of 2019, the still buoyant labour market and the significant easing of fiscal policies in large countries, gradually lose some of their strength due to cyclical and political causes.

Market impact | The ECB has signalled that it stands ready to deploy new tools to face a slowdown, however its room for further stimulus is limited. A coordinated fiscal stimulus would be also be very difficult to decide due to the complex European institutional and political environment. Therefore, a major slowdown would clearly be negative for European assets and the Euro.

Risk # **4** | **20%** probability | Re-escalation in trade tensions between the US and China

Analysis | At first glance, the outcome of the G20 is encouraging. Trump bought time. But in substance, the truce reached does not change much. The most complex issues (intellectual property rights, technology transfers) were not addressed at the G20. The confrontation between the US and China will therefore return to the forefront sooner or later. It should not be forgotten that the US is entering a pre-election period. The opposition to China goes far beyond the Republicans. Whoever the US President is next year, the opposition between the two countries on strategic issues could worsen their relations in the coming years. It is therefore important not to misunderstand the context. The protectionist rhetoric will not disappear from the radar screens. The likelihood of a global trade agreement is very low. And in the end, there is still a great risk that Donald Trump will impose a tariff increase on an additional $300bn of imports from China, even if not immediately, and at a lower rate (more likely 10% than 25%). Tariff uncertainty is long-lasting, which is clearly not good news for investment and trade..

Market impact | There was some market relief after the G20 meeting rather than a strong rally, as some progress in the trade disputes were somehow already priced in and the expectations for a full deal are still very low. Global trade and the global manufacturing sector will likely remain under pressure in H2 2019. Uncertainty remains high.

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

Analysis | The US economy was stronger than expected in Q1, although the composition of growth was somewhat volatile and sent out mixed signals, as almost half of the boost came from inventory growth and net trade. Incoming data related to H1 are more mixed and point to a gradual convergence towards the potential growth rate. Signs of a somewhat more pronounced deceleration in investments and capex require monitoring, while the still strong, albeit decelerating labour market, points to moderating yet resilient consumption. Keep an eye, however, on both hard and soft data, as soft data may give leading signals but can sometimes be misleading; we are watchful of the protracted weakness in the manufacturing sector, which represents a small part of the US economy but may spill over to the service sector. Renewed tensions on the trade front with China with the step-up in tariffs, the still open risk of tariffs on cars imported from Europe (postponed by six months), and uncertainty surrounding the very important process of ratifying the USMCA (aka NAFTA 2.0) add uncertainty to the risks in our outlook. The probability of recession remains contained in the near future, as the Fed has turned more dovish with a risk management approach designed to prevent negative spill-overs from the trade front into the domestic economy by opening the door for rate cuts.

Market impact | The 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. At the time of writing, the markets have begun pricing in up to 4 rate cuts by the Fed by end of 2020, the first one occurring as soon as July 2019.

Risk # **6**

15%
probability

Major geopolitical crisis in the Middle-East

Analysis | While there are always geopolitical risks centered in the Middle- East, US -Iran tensions have increased in recent weeks after D. Trump 1/ cancelled the waivers that enabled some countries to import Iranian oil 2/decided new sanctions on Iran. Recent security incidents (attacks on tankers in the Persian gulf and the shooting down of a US drone by Iran) and aggressive declarations by both sides have only worsened the situation. An important factor is that Trump's team for foreign and security affairs is now considerably more hawkish than at the beginning of his mandate, with the appointment of personalities such as Mike Pompeo at the State Department and, even more so, John Bolton as National Security Advisor. However, Trump appears to be a lot more pragmatic than the latter. On the Iranian side, the risk of a military confrontation with the US is made larger by internal divisions, and the possibility that the IGRC could conduct operations without the full approval of the country's leaders.

Market impact | Oil prices would be the main item to watch, while a US-Iran open confrontation could be detrimental to most risky asset classes and cause a surge in safe-haven flows to the USD. However, at this point, we expect no durable upside shock on oil prices, given the high level of US shale gas production and declarations by Saudi Arabia and the UAE that they can make up for the shortfall in Iranian exports.

Risk # **7**

10%
probability

Major political crisis in Europe

Analysis | Aside from the Italian situation (see risk#3) there are few identifiable triggers for short-term systemic political risk in the Eurozone, in particular as the European election results were broadly in line with what opinion polls had indicated, even producing a slight "pro-institution" surprise. While the European Parliament is more fragmented, and European governments and institutions are having a harder time than usual negotiating appointments to the EU's top jobs (European Commission, Council, Parliament and Central Bank), this should not trigger a major crisis. However, it is far from clear that voters' support for "anti-system" parties has peaked and the presence of these parties in national parliaments is complicating the building of government majorities. Politics is therefore becoming less predictable, notably in large countries where it used to be stable (Germany and Spain). While this is manageable in good times, it may become problematic should a deterioration of the economic situation (or other emergencies) require a strong political hand. Moreover, other changes only complicate European political life further: "Pro-system" forces other than traditional political parties are also making progress (notably the Greens and the economic Liberals), while recent events in France have indicated the possibility of protest movements not led by political parties or trade unions. On the positive side, it should be mentioned that appetite for leaving the euro is diminishing, and is no longer on the agenda of major protest parties in France and Italy.

Market impact | Given the still positive economic backdrop, we do not believe that a new round of systemic crisis in Europe is possible. 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 while the difficulty to understand European institutions for outside investors means that European assets may continue to carry a specific political risk premium. Italian government spread vs. Bund should continue to be volatile.

Risk # 8 | 10% probability | Major slowdown in the "emerging world"

Analysis | The renewed wave of dovishness among the main central banks (namely the Federal Reserve and the ECB) is making the global financial environment easier for the emerging markets. A more pronounced USD depreciation is the missing factor in this environment, though it has partly started. The rosier financial picture will only spoil following an abrupt re-adjustment to the much more dovish market expectations of a more cautious monetary policy pursued by the Fed. Having said that, the amount of dovishness announced and realistically followed through should prevent idiosyncratic risks from becoming systemic risks. On the real economy side, spillovers from shocked external demand to domestic demand (mainly via capex) have been considerable in Asia, more so than in other regions. In order to see the expected stabilisation in growth and not a major slowdown, an orderly solution to the trade dispute is needed in the next few months.

Market impact | In the risk case, spreads and equity markets would once again be significantly impacted. This particularly true as emerging currencies would once again be under pressure due to capital outflows. However, the emerging world is far from being a homogeneous block, and the markets would deteriorate more in the weakest and most vulnerable countries, due to their poor external positions or fragile fiscal and political conditions.

Risk # 9 | 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 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...

MACROECONOMIC CONTEXT

Our convictions and our scenarios

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

Central scenario (70% probability): resilient domestic demand and services despite the uncertainty adversely affecting trade

- **Slower global growth:** after rebounding in Q1, growth slowed significantly in Q2 in the United States and Europe. Industrial surveys show that the global manufacturing sector is in recession. However, domestic demand remains resilient due primarily to household consumption which continues to be buoyed by the labour market. In these conditions, the services sector has proved resilient.

- **Global trade is under pressure, but its importance must not be overestimated:** global trade has plummeted over the last 18 months. Protectionist rhetoric has increased the level of uncertainty and caused investments to plunge in numerous trade-sensitive countries. Trade is expected to remain under pressure in H2 and grow at a lower pace than global GDP. That said, we believe that domestic demand’s resilience is underestimated. While global trade has effectively made a strong contribution to global growth over the last few decades, this is increasingly less so, with global growth being driven primarily by domestic demand. And the services sector is increasingly less correlated to industry, which can be attributed to the relative importance of consumption in relation to investments and trade since the 2008 crisis.

- **United States: gradual return to its potential.** The US economy has been boosted by a very accommodative fiscal policy, whose impact is expected to gradually diminish in H2. Real GDP growth significantly exceeded expectations in Q1 2019 (3.1% quarter-on-quarter on an annualised basis after 2.2% in Q4 2018) but growth slowed sharply in Q2. However, given the very accommodative monetary and financial conditions, we believe that in the absence of a major shock affecting these conditions or significant change in corporate and consumer confidence, the slowdown should remain contained. Investment looks set to slow. However, we think it unlikely that there will be a recession in 2019 or 2020, as household consumption is expected to continue to benefit from the increase in disposable income. Nevertheless, if trade and geopolitical tensions persist, doubts concerning the extension of the current cycle could intensify over the next few quarters (less support from fiscal policy, domestic demand under pressure with contagion from industry to the services sector). Moreover, it is important to bear in mind that below normal growth could trigger a contraction in profits.

- **Eurozone:** growth rebounded by 0.4% quarter-on-quarter in Q1, which was a relief after a very weak H2 2018. In Germany, the main economic power in the eurozone, growth also came out at 0.4% after two quarters of virtual recession. The high level of German consumer spending demonstrated that the repercussions of the weaknesses in the manufacturing sector on the economy as a whole had, hitherto, remained limited. However, there was a fairly significant deterioration in the eurozone's Q2 data, particularly with regard to manufacturing indicators. The services sector continues to expand, albeit at a moderate pace and the unemployment rate continues to decline. In terms of risk, the eurozone economy remains exposed to trade tensions. Despite the deferment of increased US customs duties on European cars, Donald Trump having postponed his decision to mid-August, European companies may nevertheless be affected by China-US tensions via the global value chains. Brexit has also returned to centre stage since, with the arrival of a new Prime Minister, the probability of the United Kingdom withdrawing from the EU with no deal has increased. Finally, with regard to domestic policy, the result of the European elections was a relief since anti-system parties did not obtain more votes than the polls anticipated, despite making progress. However, confrontation could resume between the anti-system coalition in power in Italy (the Northern League feeling strengthened by its gains in the elections) and the European authorities over the 2020 Italian budget issue. In Germany, following the poor performance in the European elections of the two coalition parties in power, the risk of rupture has also slightly increased.

- **United Kingdom:** political visibility in the United Kingdom is very limited. Boris Johnson will probably succeed Theresa May and adopt a tougher approach on Brexit, increasing the risk of the country withdrawing with no deal. However, given that Parliament remains firmly opposed to a no deal, a number of Brexit scenarios remain possible. There are likely to be heightened tensions between the UK government and the EU with the approach of the deadline (31 October). A no deal withdrawal from the EU remains the default option if the two parties fail to reach an agreement. Therefore, uncertainty will continue to adversely affect the economy over the coming months.

- **China:** the authorities have multiplied monetary and fiscal stimulus measures over the last year, which has helped cushion the shock related to the slowdown in global trade. Negotiations between China and the United States will resume following the G20 summit in Osaka. There is some good news (absence of a deadline, suspension of the prohibition on US companies continuing to provide Huawei). The pressure on global value chains should therefore subside, particularly in the technology sector. However, tensions look set to return to centre stage sooner or later with regard to strategic issues (intellectual property rights, technology transfer), on which no progress has been made. We cannot rule out renewed tensions between the United States and China. Therefore, the Chinese authorities cannot let down their guard.

- **Inflation:** underlying inflation remains low in the advanced economies. The slowdown in inflation over recent years is primarily structural, since it is tied to supply factors, while the cyclical component of inflation has weakened (with the flattening of the Phillips curve). Underlying inflation is only expected to accelerate slightly in the advanced economies. In theory, an “inflationary surprise” remains possible with the pick-up in wages (in the Unites States and eurozone) but it is striking to see that inflation has slowed in the United States, whereas real GDP growth has accelerated! In the eurozone, against a backdrop of low inflation, we believe that companies have virtually no power to fix prices (margins under pressure). Ultimately, in view of low inflation and the increase in downside risks, the majority of central banks have done a U-turn in terms of communication, since the beginning of the year.

- **Oil price:** fears of a global slowdown and the increase in US production are exerting downward pressure on oil prices which is creating concern among Middle Eastern countries. In response, OPEC countries and 10 other countries including Russia signed a cooperation agreement at the beginning of July, which de facto creates enlarged OPEC. All these countries (OPEC+) – which account for 50% of global production (vs. 30% for OPEC) - have renewed (for nine months) their agreement of last December aimed at reducing their cumulative supply by 1.2 million barrels/day in relation to their production in October 2018. Ultimately, we believe that supply pressures will continue to drive prices upwards, whereas fears concerning the trend in global demand should keep them under pressure. Therefore, all things considered, we maintain our target of $60-70/barrel (Brent).

- **Central banks durably accommodative:** the Fed is in “wait-and-see” mode. We expect a preventive cut in its rates of 25bp in 2019 (as an “insurance policy”), but barely more in the case of our central scenario in which consumption proves resilient. We consider market expectations (decline of 100bp in 12 months) to be excessive unless, naturally, downside risks were to materialise. In terms of the ECB, Mario Draghi clearly opened the door at Sintra to a cut in its rates and/or a securities purchase programme (QE) if the situation does not improve. We do not expect a cut in the deposit rate (unless the Fed aggressively lowers its rates and/or the euro appreciates significantly above $1.15). However, we expect the announcement of a new corporate bond purchase programme in September. A two-tier system is seriously being considered for deposit rates, in order to reduce the charge on banks that have substantial surplus reserves (Germany).

Downside risk scenario (30% probability): marked economic slowdown due to the trade conflict, geopolitical crisis or sudden revaluation of risk premiums

- The G20 truce is not lasting: new escalation in trade tensions between the United States and China, or between the United States and Europe.
- Series of uncertainty shocks (global trade, Brexit, Italy) that could cause global demand to plummet.

Consequences:

- All other things being equal, a trade war would lead to global trade plunging, triggering a synchronised and durable slowdown in growth and, in the short term, inflation. That said, a global trade war would rapidly become deflationary by creating a shock on global demand. Counter-cyclical fiscal and monetary policies would be rapidly implemented.
- Sudden revaluation of risk on bond markets and decline in market liquidity. Fears of recession in the United States.

Upside risk scenario (5% probability): recovery in global growth in 2020

Donald Trump does a U-turn, reducing the obstacles to trade. On the domestic front, the subject of the increase in infrastructure spending could return to the forefront and help extend the cycle in the United States.

- Acceleration driven by corporate investment and the recovery in global growth. The United States' pro-cyclical fiscal policy leading to a stronger than expected acceleration in domestic demand. Acceleration of growth in Europe after a marked decline. Recovery of growth in China due to a stimulating policy mix.
- Belated reaction by central banks which, initially, are likely to maintain accommodative monetary conditions.

Consequences:

- An acceleration in global growth that would increase inflation expectations, obliging central banks to consider normalising their monetary policy more quickly.
- Rise in real key interest rates, particularly in the United States.

Macroeconomic picture by area

United States

The Fed shifts to a risk management approach in order to engineer a soft landing

- Key drivers of domestic demand are decelerating progressively, especially on the investment side, while fundamentals remain more supportive for the US consumer; we expect monetary policy to smooth financial conditions and accompany this normalisation.
- Labour market and wage growth, albeit starting to convey more mixed data, coupled with contained inflationary pressures, are supporting resilience in personal consumption; expectations also remain broadly upbeat, while retail sales are normalising around their longer term trends.
- Business confidence has moderated appreciably compared to last year, and this is translating into a moderation in capex intentions and investments, which are expected to slow going forward.
- Moderate domestic and external inflationary pressures are keeping both core and headline CPI in check, although the Federal Reserve may start being concerned by the persistence of low inflation and the risk of a downward shift in inflation expectations, for the effectiveness of its monetary policy transmission. The central bank conveyed a dovish message at its June meeting, anticipating possible cuts in response to heightened risks to the outlook from trade issues. We are now pencilling in three rate cuts in the next 12 months, linked to the Fed's "risk management approach", rather than to increased recessionary risks. A soft landing remains the target.

Risk factors

- **Tariffs risks may negatively impact economic performance, both directly (in prices and orders) and indirectly (in confidence). The longer the list of goods included in tariffs, the higher the impact on U.S. domestic demand**
- **Renewed policy uncertainty may hold back new capex plans more than expected**
- **Geopolitical risks (Iran, Venezuela) and tariffs, could represent an upside risk to oil prices and to our inflation outlook**

Eurozone

Moderate growth expected. Risks are considerable

- After the rebound in Q1 growth (+0.4%) Q2 indicators are pointing to a slowdown. Activity remains robust in services but the manufacturing sector is sluggish. Things are returning to normal in the automotive sector after the shocks of 2018, but rising trade tensions are dragging down confidence and investment.S
- A no-deal Brexit in October would have an economic cost to the euro zone (albeit less so than for the UK itself). Tense fiscal negotiations are expected between Italy and the European Commission.

- **Trade war and threat of US tariffs on the European automotive industry**
- **A no-deal Brexit**
- **Political tensions in Italy**

United Kingdom

The possibility of a no-deal Brexit cannot be ruled out.

- After the rebound in growth in Q1 (+0.5%, driven mainly by precautionary spending), the economy is likely to slow down, as the risk of a no-deal Brexit and trade tensions weigh on confidence.
- Boris Johnson and Jeremy Hunt, the two remain candidates in the race to replace Theresa May as prime minister, say they would be willing to accept a no-deal Brexit if the EU refuses to make new concessions. Parliament, however, is opposed to this, which points to a very tense political situation in autumn 2019.

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

Japan

Get there, but hurdles remain

- The Ministry of Economy and Industry upgraded its assessment of production to "stabilization" from "weakening", due to modest progress in inventory adjustments. Machinery orders rose in April for the third straight month, suggesting that spending on equipment will be sanguine in the next few quarters. An official corporate survey shows that companies plan to boost capital spending by 9% this year.
- However, the corporate sector is vulnerable to escalation in the US-Sino trade conflicts. Export volume plunged in May to its lowest level in three years as US President Trump hinted at imposing higher levies on a wider range of Chinese products.
- Wage growth has levelled off, reflecting a somewhat eased labour market. As a consequence, households have started saving more and consuming less, and retail sales were therefore slightly less strong.

- **Supply chain disruption on the back of the intensified trade dispute between the US and China**
- **Global economic deceleration dampens companies' capital expenditure motivations**
- **A consumption tax hike in October 2019 could exacerbate the economic downturn**

China

- The surprising turnaround in US/China negotiations and tariff increases on $200bn of Chinese goods have been adding new downward pressures to China's economy.
- A new truce was achieved at the G20 in Osaka in late June, providing that no further tariffs would be imposed on the remaining US imports from China and talks between the two countries would resume. In addition, a partial relaxation on the Huawei ban was announced. This is an overall positive outcome for the time being.
- Exports in May were hit again (0.5% YoY), but less so than in Q4.
- Policymakers look better prepared than last year, with all measures on the table ready to use if and when necessary.
- Meanwhile, there are signs that policy supports since Q3 are starting to pass through into real economy and are becoming more visible.
- RMB should be able to avoid large depreciation, barring any further major escalations, helped by policy supports and capital control.

Risk factors

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

Asia (ex JP & CH)

- In Q2 2019, the region (with regard to emerging countries) experienced the weakest macro momentum in terms of spillover from the external demand shock to domestic demand. In relative terms, the strongest deterioration was in Malaysia, Thailand and South Korea.
- The region's inflation figures have remained very benign. Food prices have been pushing up the cost of living quite broadly on the back of agro prices, which have increased lately. Having said that, CB targets are not at risk for the time being.
- In June, we saw central banks in the region in wait-and-see mode even though we keep expecting more easing to come. BoT and BoK showed more dovishness in their rhetoric.
- On 27 June, two months after the national elections, the Constitutional Court in Jakarta declared Jokowi as the Indonesia president, dismissing Prabowo Subianto's appeal.

- **Still weak macro momentum in the region**
- **Inflation still very benign. Food prices have been driving inflation up**
- **Central banks in the region in a wait-and-see mode. More easing to come**
- **Jokowi officially confirmed as President of Indonesia for a second term**

Latam

- Based on second-quarter readings, we do see some persistent weakness in the two main countries in the region: Mexico and Brazil. These poor macroeconomic figures relate more to domestic than external demand.
- On the inflation front, the overall environment remains benign. Mexican inflation has resumed converging towards the target, with its latest figure at 4.3% YoY, down from 4.4% YoY. Argentina inflation disappointed, at 57% YoY in May.
- The region's main central banks left their monetary policy rates unchanged. On 8 June, Chile's central bank cut its Policy Rate by 50bps, from 3.0% to 2.5%.
- During the month of June, the pension reform discussion in Brazil gathered some positive momentum. Votes are expected soon from the Special Committee and the Lower House (in a plenary session).
- Moody's and Fitch downgraded Mexico sovereign and Pemex.

- **Economic conditions continued to weaken in the second quarter of the year**
- **Inflation is benign overall. Argentine inflation in May disappointed on the high side**
- **Chile's central bank cut its Policy Rate by 50bps.**
- **Mexican sovereign rating and Pemex downgraded**

EMEA (Europe Middle East & Africa)

Russia: Real GDP growth was 2,2% in 2018 and should be close to 1.5% 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 is among the few emerging market sovereigns with "twin surpluses" in 2019, while accumulating assets in the National Wealth Fund.
- As expected, the CBR cut its policy rate in June by 25bps. We expect more cuts given decelerating inflation.

- **Drop in oil prices, stepped-up US sanctions and further geopolitical tensions**

South Africa: exit from recession, but no miracle

- High-frequency indicators are still very weak, and recent currency pressures due to a weak external environment for emerging countries and a cabinet reshuffle are only making things more complicated. With a null Q1 GDP figure, we have revised our forecast for 2019 from 1.4% yoy down to 0.8% yoy.
- 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.

- **Increased risk aversion, risk of sovereign rating downgrading, rising social demands in the run-up to elections and risk of fiscal slippage**

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

- Turkey's GDP decreased by 2.7% yoy in Q1-19, slightly less than in the previous quarter (-3% yoy). While private consumption slowed down less than in Q4-18, investment fell again by 13% yoy. As expected, the Government's expenditure increased sharply (+ 7.2% yoy).
- 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.

- **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
(18 June 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**	**2.5**
Japan	**0.8**	**0.9**	**0.7**	**1.0**	**0.9**	**1.3**
Eurozone	**1.9**	**1.0**	**1.3**	**1.8**	**1.2**	**1.4**
Germany	1.4	0.8	1.4	1.7	1.4	1.6
France	1.7	1.3	1.4	2.1	1.2	1.5
Italy	0.7	0.1	0.5	1.1	0.8	1.3
Spain	2.6	2.3	2.0	1.7	1.1	1.4
UK	**1.4**	**1.4**	**1.4**	**2.5**	**1.8**	**1.9**
Brazil	1.1	1.3	2.1	3.7	4.3	4.7
Russia	2.2	1.5	1.7	2.9	4.8	4.0
India	7.4	6.2	6.6	4.0	3.4	4.6
Indonesia	5.2	5.0	5.3	3.2	3.5	4.2
China	6.6	6.2	6.1	2.1	2.2	2.5
Turkey	2.9	-1.5	1.5	16.2	15.6	12.9
Developed countries	**2.2**	**1.7**	**1.6**	**2.0**	**1.6**	**1.9**
Emerging countries	**4.9**	**4.4**	**4.7**	**4.0**	**3.9**	**3.9**
World	**3.8**	**3.3**	**3.5**	**3.2**	**3.0**	**3.1**

Source: Amundi Research

Key interest rate outlook

	28/06/2019	Amundi + 6m.	Consensus Q4 2019	Amundi + 12m.	Consensus Q2 2020
US	2,50	2,25	2,15	2,25	2,05
Eurozone	0	0	-0,34	0	-0,34
Japan	-0,1	-0,1	-0,1	-0,1	-0,1
UK	0,75	0,75	0,80	0,75	0,90

Long rate outlook

2Y. Bond yield

	01/07/2019	Amundi + 6m.	Forward + 6m.	Amundi + 12m.	Forward + 12m.
US	1.75	1.50/1.70	1.62	1.40/1.60	1.59
Germany	-0.732	-0.80/-0.70	-0.78	-0.80/-0.70	-0.77
Japan	-0.215	-0.30/-0.20	-0.24	-0.30/-0.20	-0.25
UK	0.617	0.55/0.75	0.51	0.45/0.65	0.49

10Y. Bond yield

	01/07/2019	Amundi + 6m.	Forward + 6m.	Amundi + 12m.	Forward + 12m.
US	2.03	1.95/2.15	2.06	1.90/2.10	2.12
Germany	-0.31	-0.20/-0.30	-0.24	-0.15/-0.25	-0.18
Japan	-0.16	-0.20/0.00	-0.11	-0.20/0.00	-0.07
UK	0.84	0.90/1.10	0.91	0.80/1.00	0.96

Currency outlook

	28/06/2019	Amundi + 6m.	Consensus Q4 2019	Amundi + 12m.	Consensus Q2 2020
EUR/USD	1.14	1.16	1.15	1.14	1.17
USD/JPY	108	108	108	105	107
EUR/GBP	0.90	0.90	0.89	0.89	0.88
EUR/CHF	1.11	1.13	1.12	1.12	1.15
EUR/NOK	9.70	9.50	9.54	9.43	9.40
EUR/SEK	10.56	10.40	10.60	10.45	10.50
USD/CAD	1.31	10.30	1.32	1.30	1.30
AUD/USD	0.70	0.71	0.70	0.69	0.72
NZD/USD	0.67	0.68	0.66	0.67	0.67
USD/CNY	6.87	6.80	6.90	6.75	6.85

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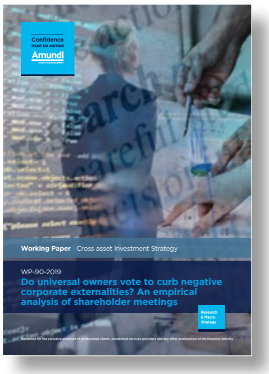
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