Amundi ASSET MANAGEMENT

Cross asset investment strategy

Research,Strategy and Analysis — WEEKLY

Letter finalised at 3pm Paris time — **June 20 - 24, 2016**

Highlights of the week

- **Markets :** Following the Brexit victory, developed countries' yields and the pound have fallen sharply. Itraxx indices have widened sharply and stock markets plunged.
- **Eurozone :** Mixed signals concerning the business climate.
- **EMEs (Emerging Market Countries) :** Russian economic indicators were mixed in May. The CBRT cut its overnight lending rate by 50bp, from 9.5% to 9% in Turkey.

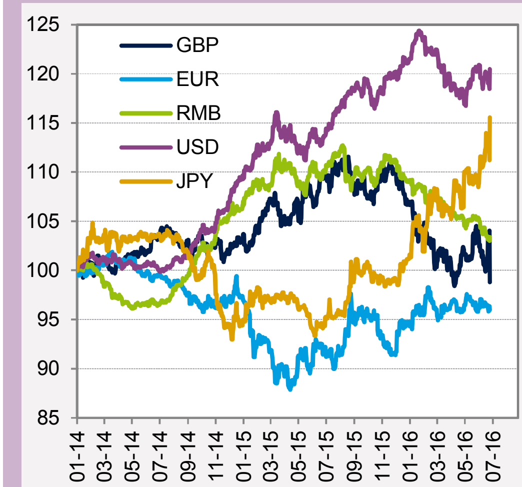
Key focus

Brexit: don't panic

After 43 years within the European Union, the UK has decided to leave. The result of the referendum was clear: 52% of voters chose "Brexit", and turnout was high. Looking beyond the result, the referendum has revealed a divided country:

- **A divide between urban and rural areas.** In cities like London 75% of people voted to remain, while in rural areas 75% voted to leave;
- **A divide between generations;**
- **A divide between regions:** England and Wales voted to leave (53.5% and 52.5% respectively), while Scotland and Northern Ireland voted to remain (62% and 56%);
- **And a divide within the ranks of political parties,** between supporters of the Bremain and supporters of the Brexit.

Nominal effective exchange rate (100 = Jan. 2014)



Source: Bloomberg, Amundi Research

In other words, the result will have a lasting impact on British society. Indeed, following this referendum on the European Union, another referendum could be on the cards, as Scotland has already announced it wants to stay in Europe, and might call for another independence referendum.

What happens next?

- **First, we should expect a new British government.** David Cameron has already announced he will step down in October, meaning that a new Prime Minister will be responsible for negotiations – probably a Brexit supporter…
- **We also need to watch the outcome of a meeting between the Union's founding members,** due to be held in Berlin on Saturday;
- **Expect the UK's credit rating to be downgraded** (by one or two notches);
- **And follow the exit negotiations.** David Cameron announced that his successor will be in charge of triggering the Article 50 of the Lisbon Treaty. Boris Johnson, the likely next prime minister, indicated that there was no emergency to trigger the Article 50 and that he wants to hold talks with Britain's UK partners before. The next European Council meeting is being held on 28-29 June. It will be the most complex divorce in history. Once the Article 50 is triggered, negotiations will take up to two years - less time if there is agreement, and more if necessary and subject to a unanimous decision by all EU members (otherwise, the UK will be outside the EU, with no agreements on trade or free movement…).

There is no doubt that the consequences of this decision will have a lasting impact. It raises political challenges for the European Union (cohesion between countries, calls for an à-la-carte Europe, a new balance of power, etc.), and will have a negative impact on the UK economy. The extent of this impact will depend on the outcome of negotiations with the EU, which will determine the harm done to the UK's exports. There are several possibilities:

- Access to the single market and membership of the European Economic Area (EEA)… like Norway, which contributes to the European budget and benefits from the free movement of goods and persons, but does not have a free-trade agreement with the EU;

- Membership of the European Free Trade Association (EFTA) like Norway, but with trade agreements negotiated with the EU, like Switzerland. Switzerland has certain restrictions like limited access to the EU for its banking industry (this is crucial to the UK);
- No specific trade agreements, but no customs duties between the UK and the EU, as is the case for Canada, for example. However, part of the Brexit camp wants to impose customs duties on the EU.
- The renegotiation of individual trade agreements with each EU country. Remember that the implementation of trade agreements involves between 4 and 10 years of negotiations.

There is a great deal of uncertainty, which explains why the markets have reacted so sharply.

Bond yields fell dramatically in Germany, in the US, in the UK and in Japan. In particular, the German 10y. yield reached a new all-time low. Credit risk premia widened significantly (peripheral sovereign bonds and corporate bonds), to reach levels slightly above that of the Greek crisis of the summer 2015. On the forex market, the pound fell heavily to reach a 31 year low vs the USD. The euro fell vs the USD as well. The yen is sharply up, what may trigger a reaction from Japanese authorities. Equity markets fell heavily, more in peripheral countries than in core countries. The banking stocks suffered as well, while this is hard to discriminate between countries. **Globally, the fall of the markets just erased the upward trend of the last few days, during which there has been a burst of optimism as several opinion polls gave the Remain ahead. This is too soon to know if the adjustment of the risk premia is over.**

That being said, it is important not to panic. The BoE is ready to take the necessary measures to restore confidence on the markets and to support the UK economy. For euro assets, the ECB's asset purchase programmes (in particular the CSPP and PSPP) and their possible adjustments will limit the risks of a too sharp widening of the spreads. Once again, central banks will rescue the markets.

The week at a glance

> Economic indicators

Eurozone >

Mixed signals concerning the business climate. The Flash estimate of the Eurozone's PMI Composite Index disappointed in June at 52.8 vs. 53 expected (and 53.1 in May). Activity is accelerating in the industrial sector but slowing in the services sector. Germany's composite PMI fell slightly, while France's composite PMI returned to a level indicating a contraction in activity. However, in Germany, the IFO indicator increased more than expected to 108.7 (vs. 107.8 in May and 107.4 expected). The German ZEW indicator (investor confidence) also provided an upside surprise at 19.2 (after 6.4 in May and 4.8 expected). On the other hand, in France, INSEE's June economic indicator was clearly disappointing.

Overall, these signals are positive for Germany but negative for France. However, it is necessary to bear in mind that the French figures had improved significantly at the beginning of the year and that a slight consolidation is normal. The main issue now is knowing to what extent Brexit will affect the business climate. We expect a moderate curb on the current recovery, which should nevertheless continue.

Russia >

Economic indicators were mixed in May. Industrial output continued to rise (+0.7% YoY vs. +0.5% in April). Construction (-9% YoY) and retail sales (-6.1% YoY), however, dropped more than the previous month (respectively, by -5.9% and -4.9%). Real wages fell at the same pace as in April (-1% YoY) but disposable household income fell less (-5.7% YoY vs. -7.1% the previous month). Meanwhile, we take note of the fact that unemployment (on a seasonally adjusted basis) levelled off at 5.8%.

These retail sales figures suggest that consumption continues to weaken even as inflation is receding and joblessness figures are stabilising. In reaction to (better than expected) first-quarter GDP growth figures, we raised our forecasts to a recession that is less serious in 2016 (-0.7% vs. -1.8% previously) and a greater rebound in 2017 (+1% vs. 0.5% initially). We are making no change to our forecasts, based on the afore mentioned figures. We continue to believe that household consumption will recover with the receding in inflationary pressures and higher wages for public-sector workers.

> Monetary policy

Turkey >

The CBRT cut its overnight lending rate by 50bp, from 9.5% to 9% but left its repo rate and its overnight borrowing rate unchanged, at 7.5% and 7.25%, respectively.

The CBRT's decision is in line with market expectations and the fact that the CBRT wants to streamline its monetary policy and bring its various rates to the same level. Meanwhile, the overnight lending rate cut was also driven by the fact that inflation is falling. We believe inflationary risks are rising with the commodities rally and that, if this continues, it could rein in monetary easing.

Financial markets

Fixed-income

Developed countries' yields have fallen sharply. The German 10-year opened at its lowest ever level on Friday, at -0.17%, before rising slightly to end the week at -0.07%. The US 10-year touched 1.40% during Friday's trading, before ending the week at 1.55%. In Europe, sovereign spreads widened only slightly, returning to levels seen during the Greek crisis in summer 2015.

Sovereign spreads did not widen as must as had been feared and are likely to narrow over the next few weeks. For the ECB, the feasibility of the PSPP is more in doubt than ever, as the Bundesbank can only purchase bonds with maturity between 7 and 31 years.

Foreign exchange

Sterling has fallen sharply, ending the week down 2.6% against the euro and 4.2% against the US dollar. European currencies depreciated. The GBP/USD exchange rate is at its lowest level for over 30 years, while EUR/USD is back at 1.11. The yen has appreciated sharply, with the USD/JPY at 102, its lowest level since August 2014. The EUR/CHF parity ended the week more or less where it was last week, as the SNB took action to stem its currency's rise. The USD/CNY has hit its highest level since the start of 2010.

Can safe havens rise any further? The SNB has already responded to upward pressure on the Swiss franc. The yen is nearing levels likely to trigger action from the Japanese authorities. The US dollar has been pushed up by the Brexit victory, while the prospect of a hike in the Fed Funds rate looks increasingly less likely, so the USD has no real upside potential.

Credit

The Itraxx indices have widened sharply following the Brexit victory. The cash markets have remained much more stable. Since the beginning of the month, we have seen a very marked underperformance by financial issuers in the eurozone periphery and by the High Yield segment. In the IG universe, non-financial issuers rated AA-A have underperformed BBB issuers. However, in the HY universe, it is B-rated issuers that have underperformed. It is also important to note the sharp slowdown in activity in the primary market.

Firstly, the CSPP has proved to be very effective in limiting tensions in the euro Corporate bond market. According to initial figures, the ECB has purchased an average of EUR 2bn of corporate debt per week since the CSPP's actual launch on 8 June. This figure is above our expectations. In addition, we believe that the underperformance of financial issuers and the High Yield segment currently offers investors attractive opportunities. Spread widening between securities eligible for the ECB programme and the rest of the universe has, in fact, been accentuated in recent days. We are particularly positive on BB-rated securities. We remain very attentive to any announcement by the ECB: the euro credit markets are highly dependent on monetary policy initiatives.

Equity

The initial reaction to Brexit has caused stock markets to plummet. The Japanese market closed down -7.2% (on the Topix) with a counterpart rise in the Yen. The other Asian markets, notably emerging markets reacted better to the news, with declines of only 2% or 3%. In Europe, the FTSE 100, comprising very international stocks, reacted better than the FTSE 250 which is much more domestic. The Eurostoxx50, which is more volatile, reacted more like the FTSE 250.

Such market declines often create buying opportunities. It is often better to wait for determined action by the authorities, notably central banks, in order to seize them. Here are several initial comments: 1) the increase in political risk is here for the long-term, which justifies a larger risk premium than previously in Europe 2) banks, especially UK banks, will continue to experience uncertainty for some time 3) lower rates or rates that are low for longer could again favour growth stocks (in relative terms) which are nevertheless already expensive 4) the trend in the exchange rate will again impact equity markets, favouring in local currencies the markets whose currencies decline 5) emerging markets, which are not in the epicentre of the risk, could emerge relatively unscathed.

Key upcoming events

Economic indicators

Eurozone : Inflation is expected to remain stable in June. **Japan :** Industrial production should decline in May.

Date	Country	Upcoming macroeconomic data	Consensus	Prior
27 June	US	Services PMI, March	51.9	51.3
28 June	US	GDP, QoQ, Q1	1.0%	0.8%
	France	Consumer confidence, June		98.0
29 June	Eurozone	Consumer confidence, June	-7.3	-7.3
	Japan	Retail sales, YoY, May	-1.6%	-0.8%
30 June	Eurozone	Core CPI, YoY, June	0.8%	0.8%
	UK	GDP, QoQ, Q1	0.4%	0.4%
	Japan	Industrial production, MoM, May	-0.2%	0.5%
1 July	South Africa	Manufacturing PMI, June		51.9
	UK	Manufacturing PMI, June		50.1
	China	Manufacturing PMI, June	50.0	50.1
	Eurozone	Manufacturing PMI, June	52.6	52.6
	US	Manufacturing PMI, June	51.5	51.3
	Eurozone	Unemployment rate, May	10.1%	10.2%
	Japan	Core CPI, YoY, May	0.6	0.7
	Brazil	Industrial production, MoM, May	0.3%	0.1%

Source : Bloomberg, Amundi Strategy

Auctions

Date	Country	Auctions of European sovereign debt [maturity, amount (if available)]
27 June	Germany	Short-term, € 1.5 Bn
	France	Short-term, € 6.1 Bn
	Italy	15 years, € 750 Mn
30 June	Italy	Amounts not available on Friday

Source: Bloomberg, Amundi Strategy

Key events

Date	Upcoming monetary policy committee meetings
14 July	Bank of England (BoE)
21 July	European Central Bank (ECB)
28 July	Bank of Japan (BoJ)

Date	Upcoming political events
	General elections in Spain
October 2016*	Italian Constitutional Referendum
November 2016	Presidential elections in the United States

Source: Amundi Strategy

* Estimated

Market snapshot

Equity markets	24/06/2016	Over 1 week	Over 1 month	Ytd
S&P 500	2113	2.0%	1.8%	3.4%
Eurostoxx 50	2777	-2.5%	-7.7%	-15.0%
CAC 40	4100	-2.2%	-7.5%	-11.6%
Dax 30	9567	-0.7%	-4.9%	-10.9%
Nikkei 225	14952	-4.2%	-9.4%	-21.4%
MSCI Emerging Markets (close -1D)	835	3.6%	6.0%	5.2%
Commodities - Volatility	**24/06/2016**	**Over 1 week**	**Over 1 month**	**Ytd**
Crude Oil (Brent, $/barrel)	48	-2.0%	-0.8%	29.3%
Gold ($/ounce)	1327	2.1%	8.1%	25.0%
VIX	24	4.3	9.3	5.5
FX markets	**24/06/2016**	**Over 1 week**	**Over 1 month**	**Ytd**
EUR/USD	1.10	-2.0%	-0.8%	1.8%
USD/JPY	102	-1.8%	-7.0%	-15.1%
EUR/GBP	0.81	2.6%	5.9%	9.3%
EUR/CHF	1.08	-0.3%	-2.5%	-0.8%
Fixed Income markets	**24/06/2016**	**Over 1 week**	**Over 1 month**	**Ytd**
EONIA	-0.35	--	--	-22 bp
Euribor 3M	-0.28	-2 bp	-2 bp	-15 bp
Libor USD 3M	0.64	--	-3 bp	+3 bp
2Y yield (Germany)	-0.65	-4 bp	-14 bp	-30 bp
10Y yield (Germany)	-0.07	-9 bp	-25 bp	-70 bp
2Y yield (US)	0.63	-6 bp	-28 bp	-41 bp
10Y yield (US)	1.55	-6 bp	-32 bp	-72 bp
Eurozone Sovereigns 10Y spreads vs Germany	**24/06/2016**	**Over 1 week**	**Over 1 month**	**Ytd**
France	+43 bp	+2 bp	+10 bp	+7 bp
Austria	+40 bp	-	+21 bp	+13 bp
Netherlands	+27 bp	+1 bp	+6 bp	+10 bp
Finland	+34 bp	+3 bp	+7 bp	+5 bp
Belgium	+47 bp	+3 bp	+10 bp	+13 bp
Ireland	+88 bp	+3 bp	+23 bp	+35 bp
Portugal	+345 bp	+16 bp	+60 bp	+157 bp
Spain	+171 bp	+17 bp	+35 bp	+57 bp
Italy	+165 bp	+16 bp	+40 bp	+68 bp
Credit markets	**24/06/2016**	**Over 1 week**	**Over 1 month**	**Ytd**
Itraxx Main	+92 bp	+7 bp	+16 bp	+15 bp
Itraxx Crossover	+387 bp	+16 bp	+66 bp	+73 bp
Itraxx Financials Senior	+122 bp	+10 bp	+28 bp	+46 bp

Source: Bloomberg, Amundi Strategy *3:00 pm Paris time*