Amundi
ASSET MANAGEMENT

# Cross asset investment strategy

Research,Strategy and Analysis

WEEKLY

**Letter finalised at 3pm Paris time**

**November 14 - 18, 2016**

## Highlights of the week

- **Markets :** Higher US yields, relatively stable German yields. The dollar is up against nearly all currencies. The euro and dollar credit markets are displaying different colours this week. The equity markets, which had been positive on average since the year began, are a little on stand-by this week.
- **United States :** Good consumption and property figures. Janet Yellen appeared before Congress to say that the next fed funds increase would come "relatively soon"
- **Eurozone :** The European Commission speaks out in favour of fiscal support for growth. GDP growth confirmed at 0.3% in Q3.

## Key focus

### The major difference from the long-term rate increase episode of 2013: the dollar

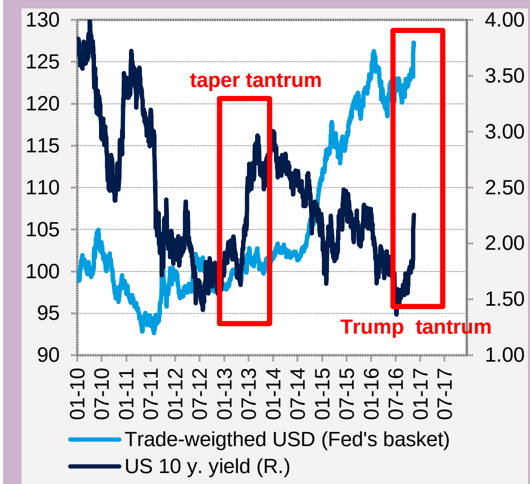
Bond sell-offs are often associated with a radical change in expectations. In May 2013, the fact that Ben Bernanke was, for the first time, talking about the possibility of a reduction of the Fed's asset purchases (QE3 tapering) had given rise to the idea that the fed funds policy was going to be tightened very quickly. The US 10-year yield went from 1.60% to 3% in early September 2013. While there was a virtual market consensus that the Fed would announce its tapering at the FOMC on 18 September 2013, the Fed had side-stepped the decision by saying that "the tightening of financial conditions observed in recent months, if sustained, could slow the pace of improvement in the economy and labour market." A two-year long decline of long-term rates followed.

**The "Trump tantrum" comes from the idea that fiscal stimulus measures taken by the future administration will substantially improve the prospects for growth and inflation.** First, rising expectations of inflation will please FOMC members, who have been bemoaning their weakness for about two years (and, by the way, if the scope of budget measures disappoints, inflation expectations could suffer once again). Second, Janet Yellen said on Thursday that the next fed funds increase would come "relatively soon" (read "December").

**But one of the biggest differences between the "taper tantrum" and the Trump tantrum lies with the US dollar.** During the "taper tantrum", the ECB and the BoJ were not aggressive, and Chinese authorities still agreed on the fact that that the US dollar and renminbi could move in tandem. Today, the monetary policies of the ECB and the BoJ are very aggressive (and will remain so), and these central banks will not tolerate a further rise of long-term rates rise (in any case, the Japanese 10Y is targeted at 0% by the BoJ). Furthermore, Chinese authorities no longer tolerate any rise in the renminbi's effective exchange rate (so the renminbi is gradually depreciating against the US dollar, and this week went even lower than the levels of the peg of 2008-2010).

**And so, the theme of monetary policy divergence and rate divergence is resurgent**. The rise in US long-term rates coincides, then, with a sharp rise in the US dollar in effective terms, unlike during the taper tantrum: despite all the fuss in 2013 (particularly over the depreciation of the "fragile five" currencies), the effective exchange rate had stayed virtually stable (stable against the euro and the yen, down against the renminbi). **The dollar's rise will be a recurring problem for the Fed in 2017 (in addition to the fact that the dollar's appreciation will weaken imported inflation), and a message from the Fed about this tightening of monetary conditions via the currency's appreciation could be what prompts the end of the Trump tantrum.** By all appearances, though, this won't happen before December's FOMC (the FOMC will not miss its chance to raise fed funds while such an increase is almost fully anticipated by the markets).

**Trade-weighted USD vs US 10y. yield**




*Source: Bloomberg, Amundi Research*

*The main currencies is the Fed's currency basket are the renminbi (22%), the euro (17%), the Mexican peso (13%), the Canadian dollar (12%) and the yen (6%).*

# The week at a glance

## > Other events

**Eurozone >**

**The European Commission speaks out in favour of fiscal support for growth.** Germany remains reticent. On Wednesday 16 November, the European Commission renounced sanctioning the budgets of Spain and Portugal (which thereby avoid suspension of European aid funds) and Italy (which is having its targets adjusted due to expenses from refugee intake and earthquakes). More generally, the Commission is supporting easing of the budgets (by around 0.5% of GDP) to stimulate growth. On Thursday 17 November, the German Finance Minister disapproved of this approach.

Part of the reason for this change in the Commission's stance on fiscal matters is the rise in eurosceptic sentiment, which could be increased by the outcome of US elections. European Finance Commissioner Pierre Moscovici said it was time to strengthen the economic recovery "faced with the rise in populist ideas". However, it will be hard to work around Germany's reluctance.

## > Economic indicators

**Eurozone >**

**GDP growth confirmed at 0.3% in Q3.** Eurozone GDP rose by 0.3% in Q3, or at a rate in line with expectations and the rate in Q2. On a country-by-country basis, growth was +0.2% in Germany and France (slightly lower than expected), +0.3% in Italy (slightly higher than expected) and +0.7% in Spain (in line with expectations). Eurozone GDP growth is 1.6% year-on-year.

The tensions in Q3 (concerns over Brexit and the situation of Italian banks, in particular) have not, for the moment, slowed down the recovery. The Italian figure is particularly welcome, given that this country is about to face the challenge of the constitutional referendum scheduled for 4 December. Our scenario anticipates an ongoing recovery in the eurozone, but the accumulation of political uncertainty is likely to prevent it from accelerating.

**United States >**

**Good consumption and property figures.** Retail sales rose by +0.8% in October (vs. +0.5% expected) after an increase in September which was itself revised upwards to +1% (vs. +0.6% announced previously). Control Group retail sales (representative of the consumption measured in GDP) also rose by +0.8% (vs. + 0.3% expected) and after a September figure revised upwards to +0.3% (vs. +0.1% announced previously). Concerning the property sector, building permits provided an upside surprise in October (1.229M vs. 1.198M expected and after 1.225M in September) as did housing starts (1.323M vs. 1.156M expected and after 1.054M in September).

Although not primarily responsible, the week’s good US figures nevertheless provide support to the major current trends in the market (increase in US yields and the dollar).

**China >**

**China’s October Fixed Asset Investment held up well.** China’s October real economic activity data came in virtually in-line. (1) China’s Industrial Production yoy growth came in slightly weaker than expected at 6.1% (vs. consensus 6.2% and previously 6.1%); (2) China’s Retail Sales yoy growth provided a downside surprise at 10.0% (vs. consensus and previous figure both at 10.7%); (3) China’s Fixed Asset Investment ytd yoy growth came in slightly better than expected at 8.3% (vs. consensus and previous figure both at 8.2%), bottoming out from August. China’s October money data came in slightly weaker than expected. M2 came in slightly better at 11.6% (vs. consensus 11.4%, and previously 11.5%), bottoming out from July, whereas total social financing came in weaker than expected at CNY896.3bn (vs. consensus CNY1trn and previously CNY1.7115trn), and new yuan loans came in virtually in-line at CNY651.3bn (vs. consensus CNY672bn, and previously CNY1,220bn).

Among the October real economic activity data, there are several highlights: 1. The improvements seen in industrial production in October relate to cement production (+3.0% yoy), Crude Steel (+4.0% yoy), and power generation (+8.0%). 2. October Property FAI yoy grew at +13.4% (vs. +7.8% in September, a significant pick-up from July and bottoming out since December 2015, which is a major contribution in terms of stabilising fixed asset investment. Also, highway FAI remained strong in October at 20% yoy (vs. +18.6% in September). We think China stabilisation is sustainable through to the end of 2017 during a political transition year.

**India >**

**India’s October wholesale prices yoy (WPI) were weaker (i.e. better) than expected at 3.39% (vs. consensus 3.74%, and previously 3.57%).** India’s October CPI yoy came in virtually in-line at 4.20% (vs. consensus 4.15%, and previously 4.39%), hitting a 7-month low.

The weakness in both the CPI and WPI is driven by lower than expected food prices given a better than expected normal monsoon season, with food inflation within the CPI hitting a 14-month low at 3.7% yoy in October, vs. food inflation within the WPI reaching a 7-month low at 3.4% yoy in October. We continue to hold our view that the

RBI's inflation outlook has been lagging in that inflation has been behaving much weaker than the RBI expected. Hence we believe the RBI has to remain accommodative longer than the market expected, and ease bigger than the market expected.

# Monetary policy

FOMC >

**Janet Yellen appeared before Congress to say that the next fed funds increase would come "relatively soon",** pointing to the progress made on the labour market.

Barring a major disappointment on job creations for the month of November, the Fed will raise its rates in December. Only afterwards will FOMC members speak of the negative consequences of the dollar's sudden appreciation.

Mexico >

**Mexico's Central Bank has raised its key rate by 50bp, to 5.25%.** This decision follows the victory of Donald Trump, which has triggered a sharp depreciation of the Mexican peso (the peso/dollar exchange rate has plummeted by around 20% since the elections). In light of Donald Trump's campaign proposals (concerning trade tariffs and trade agreements, the remittances from Mexican expatriate workers in the United States and the building of a wall at the frontier of the two countries), Mexico is among the countries likely to be the most impacted by the election.

The rise in the key rate is in line with expectations. It is aimed particularly at anchoring inflation expectations, whereas inflation for October came to +3.1% year-on-year (vs. a target of 3%). The further important decline in the peso is likely to increase inflationary pressures (*via* the pass-through effect, which has been relatively contained until now). Moreover, the Central Bank's statement highlights the importance of responding to the environment of uncertainty and the deterioration in financial and trade ties with the United States, through appropriate economic policies. Over the next few months, the challenge for the Central Bank will therefore be to subtly decide on the continuation of its restrictive monetary policy in order to respond to: i) on the one hand, the inflationary pressures due to the depreciation of the currency, the capital outflows and the Fed's normalisation policy; ii) but without further hindering economic prospects, through too high interest rates (which would adversely affect investment but also consumption by encouraging savings).

# Financial markets

## Fixed-income

**Higher US yields, relatively stable German yields.** Yield spreads between the United States and Germany have reached new highs. The US yield curve has flattened slightly on the 5-30 year segment. Breakeven inflation rates have taken a pause. In the eurozone, Italy-Spain 10 year spreads have widened, to 177 bps and 129bps respectively.

The rise of long-term yields may continue for some weeks (*cf.* editorial). Peripheral bonds should continue to suffer in the coming weeks, in the perspective of the Italian constitutional referendum.

## Foreign exchange

**The dollar is up against nearly all currencies, with the notable exception of the Mexican peso (+2.1% against the dollar for the week).** The EUR/USD exchange rate fell to 1.07, while the USD/JPY is approaching 110.

The current pace of USD appreciation is not sustainable (*cf.* editorial). It may continue to appreciate in the short run but FOMC members will worry about it rather soon.

## Credit

**The euro and dollar credit markets are displaying different colours this week.** Uncertainties over the Italian referendum of 4 December are weighing down the euro credit markets. Peripheral issues (particularly subordinated bank debt) are underperforming. US credit markets continue to benefit from the Trump effect.

Our analysis: the expected rebound in growth in the US triggered by the US elections is positive for US credit. Our models show that US IG and US HY corporate bonds still offer value. However, the increase in long-term rates and the dollar's appreciation could have an impact on corporate fundamentals that should be watched closely. We remain conservative on the lowest-rated segments of the US HY segment. On the euro market, continuation of the CSPP will be a major factor supporting the euro credit market. Our models show that the average spreads of CSPP-eligible IG non-financial bonds have become unattractive with regard to break-even values. Financial securities still offer attractive valuations.

## Equity

**The equity markets, which had been positive on average since the year began, are a little on stand-by this week.** Year to date as of 16 November, the MSCI World was positive at +2.9% in local currencies and +2.6% in US dollars. Emerging markets (+5.2% in local currencies and +6.7% in dollars) are still in the lead. They are ahead of the United States (+6.3%), the eurozone (-5.8% and -7.4% in dollars), and Japan (-8.7% but +0.3% in dollars). The British market stands at +8% in local currencies, but -9% in dollars.

Several comments: 1) The US policy mix trend toward greater fiscal spending is positive for equities compared to bonds 2) don't take dramatic risks, since the US equity market has entered a bubble 3) geographic positioning is more neutral 4) take risks more within the different zones. Take two examples: the Value theme, which profits from the increase in long-term rates, can be developed in the different regions. US small cap equities, which are more domestic, should benefit fully from the decline in corporate income tax.

# Key upcoming events

## Economic indicators

**USA :** Services PMI should remain stable in November. **France :** Manufacturing PMI is expected to decrease in November.

| Date | Country | Upcoming macroeconomic data | Consensus | Prior |
|---|---|---|---|---|
| 23 November | France | Manufacturing PMI. November | 51.4 | 51.8 |
| | France | Services PMI. November | 52 | 51.4 |
| 24 November | Eurozone | Manufacturing PMI. November | 53.3 | 53.5 |
| 25 November | Italy | Retail sales. MoM. September | - | -0.1% |
| | UK | GDP. YoY. Q3 | 2.3% | 2.3% |
| | US | Services PMI. November | 54.8 | 54.8 |

*Source : Bloomberg. Amundi Strategy*

## Auctions

| Date | Country | Auctions of European sovereign debt [maturity, amount (if available)] |
|---|---|---|
| 21 November | France | Short-term, € 6.1 Bn |
| 22 November | Spain | Short-term, amounts not available on Friday |
| | ESM | Short-term, € 1.5 Bn |
| 25 November | Italy | Long-term, amounts not available on Friday |

*Source: Bloomberg, Amundi Strategy*

## Key events

| Date | Upcoming monetary policy committee meetings |
|---|---|
| 8 December | European Central Bank (ECB) |
| 14 December | Federal Reserve (Fed) |

| Date | Upcoming political events |
|---|---|
| November 2016 | OPEC Summit - Vienna, Austria |
| 4 December 2016 | Italian Constitutional Referendum |

*Source: Amundi Strategy*

# Market snapshot

| Equity markets | 18/11/2016 | Over 1 week | Over 1 month | Ytd |
|---|---|---|---|---|
| S&P 500 | 2187 | 1.0% | 2.2% | 7.0% |
| Eurostoxx 50 | 3033 | 0.1% | -0.5% | -7.2% |
| CAC 40 | 4519 | 0.7% | 0.2% | -2.5% |
| Dax 30 | 10717 | 0.5% | 0.8% | -0.2% |
| Nikkei 225 | 17967 | 3.4% | 5.9% | -5.6% |
| MSCI Emerging Markets (close -1D) | 847 | -0.2% | -6.8% | 6.7% |
| **Commodities - Volatility** | **18/11/2016** | **Over 1 week** | **Over 1 month** | **Ytd** |
| Crude Oil (Brent, $/barrel) | 47 | 4.0% | -9.9% | 24.9% |
| Gold ($/ounce) | 1211 | -1.3% | -4.0% | 14.1% |
| VIX | 13 | -0.7 | -1.8 | -4.7 |
| **FX markets** | **18/11/2016** | **Over 1 week** | **Over 1 month** | **Ytd** |
| EUR/USD | 1.06 | -2.2% | -3.4% | -2.3% |
| USD/JPY | 110 | 3.4% | 6.2% | -8.5% |
| EUR/GBP | 0.86 | -0.3% | -3.7% | 16.6% |
| EUR/CHF | 1.07 | -0.2% | -1.5% | -1.5% |
| **Fixed Income markets** | **18/11/2016** | **Over 1 week** | **Over 1 month** | **Ytd** |
| EONIA | -0.35 | - | - | -22 bp |
| Euribor 3M | -0.31 | -- | -- | -18 bp |
| Libor USD 3M | 0.91 | - | +3 bp | +30 bp |
| 2Y yield (Germany) | -0.66 | -6 bp | +1 bp | -31 bp |
| 10Y yield (Germany) | 0.27 | -4 bp | +23 bp | -36 bp |
| 2Y yield (US) | 1.03 | +12 bp | +23 bp | -1 bp |
| 10Y yield (US) | 2.29 | +14 bp | +55 bp | +2 bp |
| **Eurozone Sovereigns 10Y spreads vs Germany** | **18/11/2016** | **Over 1 week** | **Over 1 month** | **Ytd** |
| France | +46 bp | +1 bp | +17 bp | +10 bp |
| Austria | +27 bp | +1 bp | +8 bp | - |
| Netherlands | +16 bp | -2 bp | +5 bp | -1 bp |
| Finland | +19 bp | -2 bp | +6 bp | -10 bp |
| Belgium | +39 bp | +1 bp | +15 bp | +5 bp |
| Ireland | +71 bp | +2 bp | +25 bp | +18 bp |
| Portugal | +353 bp | +35 bp | +32 bp | +164 bp |
| Spain | +129 bp | +13 bp | +23 bp | +15 bp |
| Italy | +177 bp | +6 bp | +42 bp | +80 bp |
| **Credit markets** | **18/11/2016** | **Over 1 week** | **Over 1 month** | **Ytd** |
| Itraxx Main | +80 bp | +3 bp | +8 bp | +3 bp |
| Itraxx Crossover | +344 bp | -1 bp | +13 bp | +29 bp |
| Itraxx Financials Senior | +107 bp | +8 bp | +9 bp | +30 bp |

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

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