Amundi ASSET MANAGEMENT

Cross asset investment strategy

Research,Strategy and Analysis WEEKLY

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Highlights of the week

- **The USD slightly down. Credit and Equity markets started out 2017 on a positive note.**
- **In the US, very strong ISM. Job creations remain robust.**
- **China: manufacturing PMIs stabilize within expansion territory.**

Key focus

2017: another tricky year for the Fed

While the 115th legislature of the US Congress began on 3 January and Donald Trump will be sworn in as President on 20 January, **there are still sharp questions about the new administration's economic policy, and, to put it mildly, FOMC members don't know where they stand:** *"Many [FOMC] participants noted that there was currently substantial uncertainty about the size, composition, and timing of prospective fiscal policy changes, but they also commented that a more expansionary fiscal policy might raise aggregate demand above sustainable levels, potentially necessitating somewhat tighter monetary policy than currently anticipated."* The FOMC minutes also tell us that half the participants at the 14 December FOMC incorporated an assumption of more expansionary fiscal policy in their forecasts, the other half has not. As a reminder, Janet Yellen said in a press conference on 14 December that fiscal stimulus measures were not required for the US economy to return to full employment.

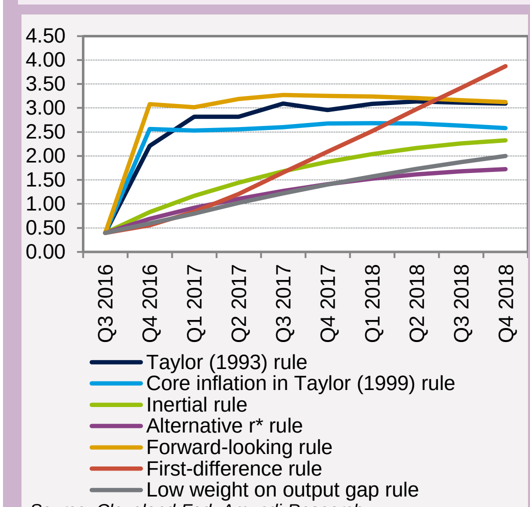
During the electoral campaign, Donald Trump was highly critical of the Fed's policy in recent years, specifically saying fed fund rates have not been raised fast enough. The media made a fuss over Yellen not being reappointed as chair of the FOMC (her term expires in February 2018). Trump will soon have to appoint two members to the Board of Governors – or even three, if Daniel Tarullo retires. **This could substantially change the balance of power within the FOMC.**

Beyond the uncertainty over economic policy, 2017 will also be marked by possible structural changes for the Fed. The platform *A Better Way*, promoted by House of Representatives leader Paul Ryan, posits that the US economy would fare better if the Fed "were more predictable in conducting its monetary policy and more transparent in its decision-making process." ***A Better Way* proposes asking the FOMC for more explanations of its monetary policy decisions and requiring the Chair of the Board of Governors to explain to Congress why its decisions about fed funds differ from a Reference Policy Rule, in other words a traditional Taylor rule.** In addition, John Allison, who is one of the people Trump could appoint to the Board of Governors, is in favour of a traditional Taylor rule. Among the other names floated for an FOMC post is… John Taylor, the Taylor rule's theorist.

Adopting a Taylor rule is highly controversial. Neel Kashkari, Chair of the Minneapolis Fed and a former Republican candidate for governor of California, is against adopting a Taylor rule, because the neutral rate has weakened so much in the last few years. **In a note published this week, Kashkari declared that the implementation of a Taylor rule over the last years would have kept 2.5 million Americans out of work.** Jerome Powell, a member of the Board of Governors, had already given a speech on 9 February 2015 denouncing the possible adoption of a Taylor rule, saying that such a rule was already used for informational purposes but that he doubted that "important decisions [could] be reduced to a single equation."

For FOMC members, 2017 will decidedly not be easier than previous years.

Fed : Taylor rules



Source: Cleveland Fed, Amundi Research

One big issue with Taylor rules is that there are many ways to calculate them. Above, we represent seven estimations done by the Cleveland Fed on November 21.

The week at a glance

Other events

United States >

Donald Trump is sending out new signals in favour of increased protectionism. Trump has nominated Robert Lighthizer as US trade representative. An attorney and a former member of the Reagan administration, Lighthizer is known for his anti-free-trade views. This appointment comes after that of Peter Navarro, a proponent of tougher trade relations with China, as the White House's chief foreign trade advisor. Meanwhile, Ford announced it was calling off the construction of a plant in Mexico and confirmed an investment in Michigan, against a backdrop in which the president-elect is constantly criticising automakers for their outsourcing practices.

There appears to be increasing risk of tense trade negotiations between the US and the rest of the world (beginning with China and Mexico). In appointing persons known for their very firm views to key posts, Trump is toughening his team's position from the outset in order to extract the most concessions possible from other countries. Keep in mind, however, that these persons must still be confirmed by the Senate, which is far from being fully under the protectionist banner. Ford, meanwhile, said that its recent investment announcements were not linked to Trump's accusations.

UK >

UK ambassador to the EU resigns. Ivan Rogers, the UK's ambassador to Brussels, has announced his resignation. This highly experienced senior civil servant, who had spoken out against Brexit, was perceived as a key individual in negotiating a "soft" exit by the UK. He had warned the government that the exit process would be complex. While proponents of a "hard Brexit" expressed satisfaction with his resignation, more moderate forces saw it as a worrisome sign.

The UK government is still providing little indication of its Brexit intentions. The prime minister has announced that she would activate Article 50 of the Lisbon Treaty, which governs the exit process for a member-country from the European Union, no later than 31 March 2017.

Economic indicators

Eurozone >

A big improvement in the business climate in December. Inflation is on the rebound. The eurozone's PMI Composite Index rose to 54.4 in December, a several-year high. This improvement was driven mainly by France's PMI Composite Index. Those of Germany and Spain did not rise as high; Italy's fell back. From a sectoral viewpoint, the improvement mainly involves industry, while a very slight erosion is seen in services. Annual growth in the headline inflation index rose to +1.1% in December (vs. +0.6% in November), the fastest pace since September 2013. Meanwhile, growth in the core index (non-energy and food) stayed very modest (+0.9% after +0.8% in November).

Our scenario calls for a slight deceleration of growth in 2017, but not enough to challenge the continued recovery. These latest indicators do line up rather well with acceleration. However, keep in mind that 2017 promises to be especially loaded in political uncertainties that are likely to hamper business confidence and therefore growth. We prefer to remain conservative. The rebound in inflation is being driven above all by the base effects of oil prices. For the time being, there are few signs of inflation tied to the European domestic market's momentum.

United States >

Robust payrolls, wages accelerate. The US economy generated 156K new jobs in December (vs 178k expected and after an upwardly revised November figure of 204K vs the previously announced 178K). The unemployment rate increased slightly to 4.7% (vs 4.6% in November) but partly due to an increase in the participation rate (62.7% vs 62.6%). Average hourly earnings advanced sharply (+2.9% yoy vs +2.5% yoy in November). The U6 "augmented" unemployment rate reached a new low at 9.2%.

Very strong ISM indicators. The ISM Manufacturing Index rose higher than expected, to 54.7 (vs. 53.2 in November and 53.6 expected) with an especially strong new orders component of 61.6. The non-manufacturing ISM Index stayed very high at 57.2 (vs. 56.6 expected).

The increase in wages shows that, beyond the temporary basis effect of oil prices, there is a genuine labor-market induced reflation in the US. To judge by the business climate indicators, Trump's election is welcome news, which creates some vulnerability should his policies disappoint.

Brazil>

Industrial production increased by 0.2% mom sa in November, partially offsetting the -1.2% mom sa October print, but lower than expected by the market consensus (+1.3%). **In yoy terms, it decreased by 1.1%** (vs -7.3% previously). In a 12-month accumulated terms, industrial production dropped 7.5% (vs -8.4% in October) and registered the 33rd consecutive month decrease in yoy terms.

Activity indicators remain very poor especially regarding markets that where expected a positive figure on yoy terms. This weakness of cyclical indicators supports our call for another recession year and for an acceleration in the easing pace of the BCB.

China > **China's December official manufacturing PMI came around in line at 51.**4 (vs. consensus 51.5 and prior at 51.7), remaining in expansion territory. China's Caixin December manufacturing PMI, came in much better than expected at 51.9 (vs. consensus and prior at 50.9).

We have been calling a stabilisation of the manufacturing PMI within expansion territory for a few months already. The stabilisation in December's official manufacturing PMI remained at a relatively high level, where input prices (69.6 in December vs. 68.3 in November) continue to surprise on the upside, which gives us confidence in a further recovery in PPI, which is the foundation of our China bottoming and China stabilisation call. The Caixin December manufacturing PMI's big improvement is broad-based, driven mainly by production (53.7 in December, vs. 52.7 in November, highest since January 2011) and new orders (53.1 in December, vs. 51.9 in November). We have extended our China stabilization call to the end of 2017, given both bottom-up and top-down forces, and we think China stabilisation is the key to global economic stabilisation in 2017.

Turkey> **Turkish headline inflation rose in December to +8.5%yoy** from +7.0%yoy the previous month. Core inflation (which excludes food and energy) also rose from +7.0%yoy to +7.5%yoy.

Terrorist attacks, debates regarding constitutional changes in the parliament and Turkish GDP growth turning negative in Q3 with the recent data revision contribute to increase risk aversion of investors towards Turkish assets. In such a context, assuming that the CBRT will not tighten quickly regarding last GDP print, we expect further fall of the Turkish lira and additional inflationary pressures.

> Monetary policy

Mexico> **The central bank of Mexico (Banxico) has intervened on the FX market to stop the fall of the peso**. Indeed, despite a drastic tightening of monetary policy - the Banxico has increased by 250bp its key rate to 5.75% in one year - the peso has lost since January 2016 almost 25% against the US currency of which more than 15% since the election of D.Trump. According to Reuters, Banxico would have sold at least 1 billion dollars. It was its first intervention on the FX market since February 2016 when it had sold for $ 2 billion to support its currency, at the time hurt by the fall in oil prices.

Faced with a devastating climate linked to the election of D.Trump and the first signs of the impact of its possible trade policy (Ford's CEO announced on Tuesday that the company was abandoning a plant project in Mexico), the Banxico's intervention would appear to have had only a temporary effect. The planned departure for the summer of the current Governor A.Carstens, much appreciated by the markets, does not facilitate the task of Banxico. In this context, there is no doubt that the peso will continue to be under pressure and that Banxico will be obliged to intervene again.

> Financial markets

Fixed-income

The US yields slightly down (down after the release of the FOMC minutes and up after the job report), the German yields slightly up. The US and German 10 y. yields hit respectively 2.39% and 0.28%. The US 10y. inflation break-even rate hit 1.3°% this week, its highest level since July 2015. In Europe, sovereign spreads widened slightly and come back to the levels that prevailed at the time of Italian constitutional referendum.

The rise of US long-term yields can continue for some weeks, in particular because of the rise of headline inflation. This being said, any declaration of the new US administration about a possible trade war might change the outlook.

Foreign exchange

The US dollar was down against virtually all currencies for the week, with the notable exception of the Turkish lira and Mexican peso, in a week marked by a slight increase in oil prices (+0.4%) and the publication of the FOMC minutes (see Editorial). The EUR/USD exchange rate was back above 1.05, and USD/JPY returned to about 117. Note that the renminbi appreciated strongly over the week before depreciating on Friday.

The USD can appreciate slightly in the coming weeks. This being said, it is one of the most overvalued currencies in the world. It will be very important to follow the debate about the possible adoption of a "border-adjustment tax" at the Congress as it would be very positive for the USD.

Credit

Credit markets put their best foot forward at the beginning of the year, with spreads tightening mainly in higher beta segments like HY and subordinated financial debt, together with positive equity performances. Financials were active in primary markets, too, as new issuance returned to normal levels after December's limited volumes. The ECB reduced its purchases to just around € 600 million per week in second half of December: the last month of the year saw the lowest monthly purchased volume, at around half the usual size (€ 4 bn vs. the average of € 8 bn). However, the programme is likely to rapidly return to pre-holiday season levels over these first days and weeks of 2017.

In 2016, both US$ and EUR denominated corporate bonds were among the best performing asset classes in fixed income markets: EUR HY delivered a 9% total return (the highest in the last three years), while US HY more than doubled these numbers, with a 17.5% cumulative total return, though if the energy and commodity sectors are excluded, the number falls to an – albeit still high – 12.7%. IG corporate bonds felt more than speculative grade bonds the negative effect produced on total returns by the recent rise in bond yields. US$ IG total return had reached a peak of 9.5% in early September, but then it retraced to a final, cumulative 5.9%. At the same time, EUR IG denominated bonds reached a yearly 4.7% total return, vs. a peak of 6.5% reached three months before. Excess returns over corresponding government bonds were also positive on both sides of the Atlantic. US corporate bonds delivered higher numbers than their EUR-denominated counterparts in this respect, with US HY reaching double digits, even excluding energy and metals & mining. Meanwhile, US IG returned close to 5%, doubling EUR IG, which posted a 2.3% excess return. Among eurozone spread products, 2016 marked a turn in relative performances delivered by corporate bonds on one side and peripheral government bonds on the other side: for the first time in years both IG and HY corporates outperformed peripheral government bonds. In each of the previous three years (from 2013 to 2015), peripheral government bonds outperformed speculative and investment grade bonds. Furthermore, after the inclusion of corporate bonds in the ECB's QE, volatility experienced by the asset class was lower than that suffered by major European government bond indices. Speculative grade and financials continue to be among the most attractive credit segments in 2017.

Equity

After rallying in the wake of Donald Trump's election and the Italian referendum, the equity markets have started out 2017 on a positive note. After gaining 5.0% from 7 November (the day before the US election) to 31 December, the MSCI World AC is up another 1.5% on the year to date as of Thursday evening. All regions have driven these gains, including +1.0% by the MSCI in the euro zone, +1.4% in the US, +2.5% in Japan, and as much as +3.1% in emerging markets (in dollar terms). In the euro zone the release of PMI indices helped drive the trend. Similarly, the Chinese Caixin manufacturing index, which in December achieved its biggest acceleration in four years, provided some reassurance on emerging markets. By sector, in Europe, banks (+2.8%) rode rising bond yields (+5bp by the Bund, +13bp by OAT, etc.) and the indefinite postponement of the Basel Committee meeting, interpreted as the sign of a possible easing in the prudential framework.

2017 got off to a positive start, but trading volumes remained light – Wall Street and London were closed on Monday – and indices fell short of symbolic thresholds, such as 20,000 points for the Dow Jones and 5000 for the CAC 40. After the strong rally of recent months and a few days from the inauguration of the new US president, the markets seem to feel the need to take stock of matters. The coming period offers considerable uncertainty – even the Fed admits as much. To what extent will Trump's plans be implemented? Will inflation truly pick up? What about coming elections in Europe? And so on. Against such a backdrop, it would not be surprising to see some profit-taking. However, if EPS figures continue to improve and if inflation continues to pick up, the equity markets are not done yet!

Key upcoming events

Economic indicators

Date	Country	Upcoming macroeconomic data	Consensus	Prior
9 January	Mexico	CPI. GA. November	3.4%	3.3%
10 January	France	Industrial production. YoY. December	-0.4%	-1.8%
10 January	Brazil	Retail sales. YoY. December	-5.90%	-8.20%
10 January	Brazil	Selic rate	13.25%	13.75%
11 January	UK	Industrial production. YoY. December	0.6%	-1.1%
13 January	US	Retail sales. MoM. December	0.50%	0.10%

Source : Bloomberg. Amundi Strategy

Auctions

Date	Country	Auctions of European sovereign debt [maturity, amount (if available)]
9 January	France	Short-term, € 7 bn
10 January	Germany	10yr inflation-indexed, € 1bn
10 January	ESM	Short-term, € 1.5 bn
11 January	Germany	10yr, € 5bn
11 January	Italy	Short-term, € 7bn
11 January	Italy	Long terme, montants non disponibles vendredi

Source: Bloomberg, Amundi Strategy

Key events

Date	Upcoming monetary policy committee meetings
19 January 2017	European Central Bank (ECB)
31 January 2017	Bank of Japan (BoJ)
1 February 2017	Federal Reserve (Fed)
2 February 2017	Bank of England (BoE)

Date	Upcoming political events
22 January 2017	France - First round of Socialist primaries
29 January 2017	France - Second round Socialist primaries
15 March 2017	Netherlands - General elections
31 March 2017	UK - Deadline for triggering Article 50 to leave the EU
23 April 2017	France- First round of Presidential election
07 May 2017	France - Second round Presidential election
September 2017	Germany - General Election

Source: Amundi Strategy

Market snapshot

Equity markets	06/01/2017	Over 1 week	Over 1 month	Ytd
S&P 500	2269	1.3%	2.6%	1.3%
Eurostoxx 50	3317	0.8%	7.0%	0.8%
CAC 40	4901	0.8%	5.8%	0.8%
Dax 30	11591	1.0%	7.6%	1.0%
Nikkei 225	19454	1.8%	6.0%	1.8%
MSCI Emerging Markets (close -1D)	882	2.3%	2.3%	2.3%
Commodities - Volatility	**06/01/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
Crude Oil (Brent, $/barrel)	57	0.4%	5.7%	0.4%
Gold ($/ounce)	1175	1.9%	0.4%	1.9%
VIX	11	-2.7	-0.5	-2.7
FX markets	**06/01/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
EUR/USD	1.06	0.3%	-1.6%	0.3%
USD/JPY	117	-0.3%	2.2%	-0.3%
EUR/GBP	0.85	0.2%	1.1%	0.2%
EUR/CHF	1.07	0.0%	-1.0%	0.0%
Fixed Income markets	**06/01/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
EONIA	-0.35	-3 bp	--	-3 bp
Euribor 3M	-0.32	--	-1 bp	--
Libor USD 3M	1.01	+1 bp	+5 bp	+1 bp
2Y yield (Germany)	-0.72	+4 bp	-3 bp	+4 bp
10Y yield (Germany)	0.28	+7 bp	-10 bp	+7 bp
2Y yield (US)	1.20	+1 bp	+8 bp	+1 bp
10Y yield (US)	2.39	-5 bp	-	-5 bp
Eurozone Sovereigns 10Y spreads vs Germany	**06/01/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
France	+54 bp	+6 bp	+11 bp	+6 bp
Austria	+25 bp	+4 bp	+4 bp	+4 bp
Netherlands	+17 bp	+2 bp	+4 bp	+2 bp
Finland	+18 bp	+4 bp	+3 bp	+4 bp
Belgium	+41 bp	+9 bp	+9 bp	+9 bp
Ireland	+68 bp	+14 bp	+17 bp	+14 bp
Portugal	+379 bp	+23 bp	+53 bp	+23 bp
Spain	+127 bp	+9 bp	+15 bp	+9 bp
Italy	+168 bp	+7 bp	+11 bp	+7 bp
Credit markets	**06/01/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
Itraxx Main	+68 bp	-4 bp	-6 bp	-4 bp
Itraxx Crossover	+286 bp	-3 bp	-31 bp	-3 bp
Itraxx Financials Senior	+87 bp	-7 bp	-16 bp	-7 bp

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