Amundi
ASSET MANAGEMENT

Cross asset investment strategy

Research,Strategy and Analysis

WEEKLY

Letter finalised at 3pm Paris time **January 9 - 13, 2017**

Highlights of the week

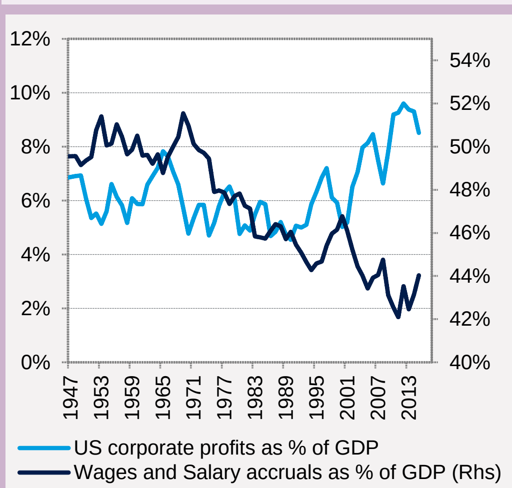
- **Markets:** US yields edged down slightly; the dollar lost ground against all the major currencies. Credit markets were more stable in recent days.
- **US:** Donald Trump's first press conference since the election. Small business confidence improving by leaps and bounds.
- **Eurozone:** Rejection of the request for a referendum on the labor market by Italy's Constitutional Court. String of good numbers continues for the Eurozone. Strong divergences within the ECB Governing Council.
- **Emerging markets:** Rise in Chinese PPI. Brazilian inflation stood at 6.29%, Brazilian Central Bank (BCB) cut the Selic rate by 75bp to 13.00%. CBRT measures following the currency depreciation.

Key focus

Margin normalisation is even excellent news for the US economy

The US labour market racked up a sixth consecutive year of solid performance in 2016. The world's number-one economy has created an average of 2.4 million jobs per year since 2010 (2.2 million in 2016), primarily in health care, education, and business services. Unemployment has fallen to its lowest point since August 2007 (4.7% in December). However, these very positive numbers must be stacked up against the historically low participation rate, which is stuck around 63%, and the very high proportion of jobs created in low-wage industries. Another negative: wage inflation for all sectors of the US economy has remained contained, despite the significant decline in the jobless rate. A turning point could come in 2017, with new tensions over wages. The latest jobs report argues for it: in December, the average hourly wage was up by 2.9%, its biggest jump since June 2009. This new trend (if it is one) is not bad news for Corporate bond investors, nor more generally for the American economy.

Corporate profit share of GDP rose to record levels



Source: Datastream, Amundi Research

- **Obviously, US corporate margins will be penalised by the rise in wages**. They are currently at historic highs, due to the corporations' very active policy of cutting production costs by capping wages. Net profit margins are currently close to 8%, which is close to their cyclical and secular record. We expect corporate margins to normalise in 2017.
- **Margin normalisation is not necessarily bad for the profit growth of American corporations.** It's extremely important to understand that the growth in profits seen during this cycle has been driven more by margin growth than growth in sales. In other words, pressure on wages has enabled corporations to increase their profits. On a macroeconomic level, the trend has resulted in very strong growth in GDP from corporate profits at the expense of labour (see graph). Raising wages would give companies more openings and – all other things being equal – increase revenue momentum.
- **The rebalancing of profits and wages is excellent news for the US economy.** Increasingly robust demand is indispensable to promoting the investment recovery. Investment has not yet returned to 2008 levels. Monetary policies have been powerless to stem this. Extremely accommodating financing terms have allowed US companies to increase their debt, but the majority has gone toward share buybacks and acquisitions. Investment spending has remained very limited. This is specifically due to the flat demand environment.

A rise in wages is not necessarily bad news for American businesses, and is even excellent news for the US economy. A rebalancing of profits in favour of wages is needed to stimulate investment and increase the growth potential of the world's number-one economy.

The week at a glance

Other events

United States >

Donald Trump holds his first press conference since the election. The President-elect announced that he would be the "greatest jobs producer that God ever created", and that he wanted to move very fast to make good on his campaign promises (specifically, building a wall with Mexico and repealing the health-care reform carried out by his predecessor). He also had to explain how he plans on avoiding potential conflicts of interest between his presidential duties and his private business dealings. In addition, he had to address the (unverified) media story that Russian secret service holds compromising information on him.

During the conference, Trump (who will be sworn in as President on 20 January) maintained a tone and attitude that were fairly characteristic of his campaign. Visibility is still limited on what measures he intends (and will be able) to take once he faces the "reality check" of his position.

Italy >

Italy's Constitutional Court rejects the request for a referendum on the labour market. The request for such a referendum was made by the CGIL (the main Italian labour union) to cancel certain provisions of the 2014 labour market reform, a flagship achievement of former Prime minister Matteo Renzi.

Such a referendum could have further weakened the government and hobbled reforms. The prospect of it also increased the probability of early elections (the only way to postpone the referendum). That said, early elections are still possible, but the Constitutional Court must first also reach a decision, on 24 January, as to the validity of the electoral law

Economic indicators

Eurozone >

The string of good numbers continues in the Eurozone. Per initial estimates, Germany's economic growth was a better-than-expected 1.9% in 2016 (1.8% adjusted for the number of days worked). This strong performance was due to vigorous private domestic demand and the increase in public spending to cope with the influx of refugees. On the other hand, foreign trade's contribution was negative. Additionally, industrial output was up by +1.5% in November (compared to +0.5% expected). Country by country, the increase was +0.3% in Germany, +2.2% in France, +0.7% in Italy and +1.7% in Spain.

In light of these figures, Q4 2016 was probably good in the Eurozone. Due to the growth carryover, this generates a bullish risk for our 2017 growth forecast (+1.3%). However, in view of the many political pitfalls that are likely in 2017, we prefer to remain conservative.

United States>

Small business confidence is improving by leaps and bounds. The NFIB survey (which measures small business optimism) scored 105.8 in December (after 98.4 in November), its highest since late 2004. Conversely, the number of job openings stood at 5.52 million in November, less than expected (5.55 million) after October's number was revised down to 5.45 million (instead of the 5.53 million announced previously). December retail sales advanced slightly less than forecast (+0,6% mom vs consensus at +0.7%) but after a November advance that was a bit stronger than previously announced (+0,2% vs +0,1%).

Expectations of the measures the new President could take are very high. The weaker-than-expected numbers on the labour market are not enough in themselves to challenge the continued improvement.

China >

China's PPI extended 4th consecutive month of positive growth after more than 4 years of contraction. December 2016 CPI yoy figures was slightly weaker than expected (which is good) at 2.1% (vs. consensus 2.2% and prior 2.3%), and PPI surprised to the upside significantly again (which is very positive) at +5.5% (vs. consensus 4.6% and prior 3.3%).

PPI figures continues to positively surprise markets, extending its positive growth for a fourth consecutive month, and reached its highest reading since September 2011. The surge in PPI was broadly based – the highlights were mining and raw materials' sectors with 21.1%yoy and 9.8% yoy growth in December respectively. Regarding CPI, warmer weather in December has resulted in mild prices of fruits and vegetables, which contributed to the slightly weaker than expected. Overall, we expect PPI inflation to stay positive throughout 2017, and CPI inflation will be modest.

Brazil >

Inflation stood at 6.29% yoy in December lower than in November (6.99%) and expected by the Reuters consensus (6.34%) and the central bank (6.48%). Underlying inflation remains slightly higher at 6.94% yoy but also lower than in the previous month (7.38%). It should be noted that this decrease in inflation affects all of the components.

For the first time since 2014, inflation has fallen below the upper limit of the BCB target (6.5%). Without any external shock, this trend should continue insofar as the labour market remains very deteriorated. By the end of 2017, inflation could have returned to 5%.

Monetary policy

Eurozone >

Strong divergences within the Governing Council. On Thursday, the ECB published the minutes of the Governing Council meeting on 8 December, during which it was decided to extend the QE until December 2017 at a reduced pace (€60 bn per month). This reveals a great divergence in viewpoints among Council members. While a majority was in favour of extension at a reduced pace, the idea of a longer extension (beyond December 2017) was also discussed, as was a shorter extension (just six months), while a few members were opposed to the very idea of continuing the QE.

Discussions will be increasingly tense in the Council of Governors in 2017. Two camps are facing off: those who think the QE was only justified because there were deflation risks, and those who think the QE is still necessary because core inflation is rising too slowly. On that note, Mario Draghi's message – and that of the Board's members – should stay focused on the weakness of core inflation.

Brazil >

The Brazilian Central Bank (BCB) cut the Selic rate by 75bp to 13.00%, accelerating the easing pace from the previous 25bp cut and more than expected by the consensus (50bp). The decision was unanimous. In the BCB post-meeting statement, this decision is justified by several factors: 1) a weaker than estimated activity level that accentuated the risk of an "even more" delayed and gradual than expected recovery, 2) disinflation dynamics more pronounced than expected by the BCB while inflation expectations are anchored and 3) an external backdrop that remains uncertain but which impact has appeared limited for the time being.

While in November we anticipated a Selic at 12% by the end of 2017, it would seem that the conditions are there, especially no massive capital outflows- for the BCB to maintain the pace that it printed during this last Copom. In this background, by the end of 2017, the BCB's rate could be single-digit i.e. fall below 10%.

Turkey >

Following the sharp fall of its currency, the CBRT released a press release on the measures it has taken : 1) lowering the bank's borrowing limits to TKL 22bns, 2) reducing FX reserve ratios by 50 bp for all maturity brackets ie additional liquidity of 1.5 bn USD and 3) clearly expressed its intention to go further if necessary.

Economic performances worsened sharply in 2016 H2 with (geo)political issues (internal and external) and rating downgrades putting the economy into negative territory. In this context, Turkish assets, especially the currency, faced strong pressures. Trump's election just amplified the phenomena (since November the Turkish lira fall by 17%). As investors don't expect much improvement on the political side, we think that the measures taken by the CBRT will not be sufficient and that there is a chance of further CBRT action in the coming days.

Financial markets

Fixed-income

US yields edged down slightly, German yields up slightly. The month-long decline in long-term yields was exclusively caused by the drop in real rates, while break-even inflation continued to increase slightly. In the eurozone, sovereign spreads were contracting. Portuguese spreads are at their lowest levels since early 2014.

Base effects on inflation will be very strong through January and February, which should benefit break-even inflation over the coming weeks. On the other hand, more questions on fiscal stimulus measures in the United States would be bad for real rates.

Foreign exchange

The dollar lost ground against all the major currencies over the week. Special mention goes to the Australian dollar, the yen and the New-Zealand dollar which gained 2.4%, 0.8% and 2.0%, respectively. Among the only currencies losing ground vs. the USD, 1) the Turkish lira lost 3% against the dollar especially due to a critical note from Moody's on the country's economic outlook. According to the agency, a sharp rise in security risks in recent years led to the deterioration in the country's economic situation which could in turn lead to a spike in the volume of non-performing loans held by Turkish banks. 2) The Mexican peso lost more than 2% against the USD in spite of the Banxico's efforts to lift the currency from its record lows (the central bank has sold dollars to support the peso in recent days). The "push to parity movement" recently observed on the EUR/USD eased somewhat during the week and the euro returned to 1.06.

The dollar's poor performance this week could be mostly explained by the lack of details about Donald Trump's policy plans during his long-awaited first news conference, which countered market expectations. However, this movement could be short lived as 1) Trump's government will officially start in a few days and thus further details on policies are going to officially come out; 2) the recent talks about the possible adoption of a "border-adjustment tax" and 3) the Fed's monetary policy tightening cycle. All these elements will support the USD in the short run, even though the USD is one of the most overvalued currencies.

Credit

After the positive start of the first week of the year, credit markets were more stable in recent days, in line with other risky assets. The primary market usually returns to its regular activity volume in January, but this time the number of new issues is particularly high. In the first six working days of the year, in fact, a record number of new deals (around 40) in EUR-denominated debt were announced, close to EUR 35bn in cumulative issuance. Even taking into account the debt issued in the form of covered bonds and other financial debt, the role of non-financials remained important, with many deals coming from the auto sector. This trend is likely to continue in the coming weeks.

Strong primary market activity was well absorbed by spreads, which remained quite stable also despite a less positive tone in other risky assets. Investors' demand is supportive while the ECB is likely to return to its usual monthly purchase levels, after December's slowdown to around half the previous monthly average in light of the holidays season's low volumes. HY bonds are likely to attract most of investors' interest in the euro area, especially in the short-term segment of the yield curve.

Key upcoming events

Economic indicators

Germany: ZEW economic sentiment is expected to improve strongly in January. **China:** GDP Q4 should be stable.

Date	Country	Upcoming macroeconomic data	Consensus	Prior
17 January	UK	CPI. GA. December	1.4%	1.2%
	Germany	Indice Zew economic sentiment. January	18.8	13.8
18 January	UK	Unemployment rate. November	4.8%	4.8%
	Eurozone	CPI. YoY. December	1.1%	0.6%
	US	CPI. YoY. December	2.1%	1.7%
19 January	US	Philadephia Fed survey. January	15.1	19.7
	China	GDP. YoY. Q4	6.7%	6.7%
	China	Industrial production. YoY. December	6.1%	6.2%
20 January	UK	Retail sales. YoY. December	-0.1%	0.2%

Source : Bloomberg. Amundi Strategy

Auctions

Date	Country	Auctions of European sovereign debt [maturity, amount (if available)]
16 January	France	Short-term, € 6.4 bn
17 January	Germany	1 year, € 5 Bn
	Spain	Short-term, amounts not available on Friday
19 January	France	2 years, amounts not available on Friday
	Spain	Long-term, amounts not available on Friday

Source: Bloomberg, Amundi Strategy

Key events

Worth watching: The monetary policy committee of the European Central Bank (ECB)

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	13/01/2017	Over 1 week	Over 1 month	Ytd
S&P 500	2270	-0,3%	-0,1%	1,4%
Eurostoxx 50	3314	-0,2%	2,4%	0,7%
CAC 40	4909	0,0%	2,2%	1,0%
Dax 30	11592	-0,1%	2,7%	1,0%
Nikkei 225	19287	-0,9%	0,2%	0,9%
MSCI Emerging Markets (close -1D)	897	1,8%	2,2%	4,0%
Commodities - Volatility	**13/01/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
Crude Oil (Brent, $/barrel)	56	-2,4%	0,1%	-1,9%
Gold ($/ounce)	1195	1,8%	3,1%	3,7%
VIX	12	0,2	-1,2	-2,5
FX markets	**13/01/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
EUR/USD	1,06	1,0%	0,2%	1,2%
USD/JPY	115	-1,8%	-0,3%	-1,8%
EUR/GBP	0,88	2,2%	4,3%	2,6%
EUR/CHF	1,07	0,1%	-0,3%	0,1%
Fixed Income markets	**13/01/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
EONIA	-0,35	-	--	-2 bp
Euribor 3M	-0,33	-1 bp	-1 bp	-1 bp
Libor USD 3M	1,02	+1 bp	+6 bp	+2 bp
2Y yield (Germany)	-0,72	+1 bp	+3 bp	+5 bp
10Y yield (Germany)	0,33	+3 bp	-3 bp	+12 bp
2Y yield (US)	1,19	-2 bp	+3 bp	-
10Y yield (US)	2,38	-4 bp	-9 bp	-6 bp
Eurozone Sovereigns 10Y spreads vs Germany	**13/01/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
France	+47 bp	-6 bp	+3 bp	-1 bp
Austria	+19 bp	-6 bp	-5 bp	-3 bp
Netherlands	+10 bp	-7 bp	-4 bp	-5 bp
Finland	+12 bp	-7 bp	-5 bp	-3 bp
Belgium	+35 bp	-6 bp	+4 bp	+2 bp
Ireland	+58 bp	-9 bp	+1 bp	+4 bp
Portugal	+359 bp	-17 bp	+19 bp	+3 bp
Spain	+111 bp	-13 bp	+4 bp	-7 bp
Italy	+158 bp	-8 bp	+7 bp	-3 bp
Credit markets	**13/01/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
Itraxx Main	+70 bp	+1 bp	-1 bp	-2 bp
Itraxx Crossover	+290 bp	+3 bp	-6 bp	+1 bp
Itraxx Financials Senior	+87 bp	-	-6 bp	-6 bp

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