Letter finalised at 3pm Paris time **July 03 - 07, 2017**

Highlights of the week

- **Markets:** sharp rise in yields in Germany; the US dollar was up against virtually all currencies**.** Cash credit indices proved resilient to the sharp rise in yields in Germany Equities had a calm start to the third quarter.
- **Eurozone :** the economic environment remains healthy.
- **US :** high level of job creations in June.

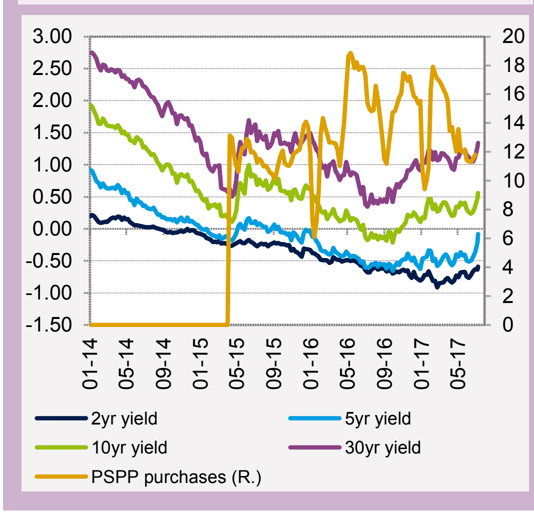
Key focus

It's already been a hot summer on the bond markets

The repercussions of Mario Draghi's speech on 27 June ("*Accompanying the recovery*") continue to be felt on the bond markets. The German 10-year yield climbed 11 bp this week to reach 0.57%, its highest level since the very beginning of 2016.

The ECB has very clearly marked a shift in its communication in recent days. As a reminder, while choosing his words with care, Mario Draghi expressed his confidence in the inflation outlook. In particular, he indicated that "*as the economy continues to recover, a constant policy stance will become more accommodative, and the central bank can accompany the recovery by adjusting the parameters of its policy instruments*." This week, it was the governor of the Bank of France who indicated that accommodative monetary policy was "*effective*", but *"not eternal, or omnipotent*", and that "*nominal rates tend to increase based on the economic recovery and inflation.*" The minutes from the most recent Governing Council meeting pointed to consideration of whether to withdraw the easing bias attached to the QE programme (ie withdraw the option to increase its size and duration).

German sovereign yields and weekly PSPP purchases (€bn)



Indeed, there are obstacles in the ECB's path, with the appreciating euro and falling oil prices. The effective euro exchange rate tracked by the ECB (a basket of 38 currencies known as the EER 38) returned to its highest levels since the summer of 2014, a period that preceded the ECB's QE announcement. Above all, the euro is now 2.3% higher than it was when the most recent economic projections were made (the 2018 inflation forecast had already been reduced from 1.6% to 1.3%) and the price of Brent is 5% lower. If things were to remain the same, the 2018 inflation forecasts would be revised downward once again.

However, it is the core inflation trend that will determine how the ECB acts and above all its conviction that the economy (and the labour market in particular) is on the right track. We should recall when Ben Bernanke spoke about the Fed "tapering" its QE in May 2013, core inflation was only 1.4% and slowing down. It is first and foremost the solid trend in the economy and the labour market that caused the Fed to "recalibrate" its monetary policy.

What can we make of these market trends?

- The marked fading of political risk in Europe and the abandon of the idea of further cuts to deposit rates have allowed German short rates to recover since early June. This trend will continue over the coming months.
- The markets were too pessimistic over the outlook for fed fund rate hikes over the next 18 months, and they still are (only two increases are being priced in between now and the end of 2018). The bond sell-off also comes from the rather hawkish tone of the FOMC minutes published this week.
- Inflation breakevens remain much too low in Europe and will increase thanks to rising core inflation over the coming months.
- The steepening of the short end of the curve is consistent with upcoming, but not yet imminent, monetary policy normalisation.
- A positive factor against this backdrop of rising long rates is seeing that spreads (peripheral, credit) remain broadly stable, but a return to a more fundamental valuation would impact certain countries.

Ultimately, this trend has good reason to continue for a while longer yet. Benoit Coeuré explained on Wednesday that "*he didn't think that this type of market reaction was particularly significant when looking at the bigger picture, especially with the economic forces at work.*" However, the ECB will surely calm things down if rates rise too far too fast.

The week at a glance

Other events

Germany >

Germany's two main political parties announced their manifestos ahead of September's elections. Angela Merkel's CDU/CSU (right) has just published its manifesto and is planning income tax cuts (around €19 billion over four years, equivalent to 0.15% of GDP per year), gradual elimination of the reunification tax surcharge, an increase in child benefits and efforts on security and housing. It was also indicated that the 2015 refugee open door policy would not be repeated. Prior to that, the SPD (left) had announced its own campaign promises – income tax increases on the highest earners and cuts for the lowest, a €30 billion investment programme for infrastructure, schools and childcare facilities, extensions to unemployment benefits and restrictions on the use of temporary employment contracts. The party is also committing to maintaining pension levels against a backdrop of an ageing population and, like the CDU/CSU, to increase security spending. With regard to Europe, the SPD's programme is more in favor of continued integration (coordination of economic policies, shared budget for investment, a European monetary fund and a fund for youth employment).

Angela Merkel is still ahead in the polls, but will probably have to continue to govern as a coalition (several options are possible). In any case, in order for Germany to accept further progress in terms of European integration, it is vital that the French government first adheres to its promises for reform and budgetary commitments.

Economic indicators

Eurozone >

The economic environment remains healthy. At 56.3, the final PMI index for June remains at a very high level despite a slight erosion in relation to May (56.8). Its manufacturing component continued to increase (57.4 vs. 57 in May) whereas its services component was weaker (55.4 vs.56.3). Industrial production provided an upside surprise in May in Germany (+1.2%, vs. +0.3% expected) and especially in Spain (+3% vs. +2% expected). Finally, the unemployment rate remained stable in May at 9.3%. On a country-by-country basis, in Eurostat-normalised data, it was 3.9% in Germany, 9.6% in France, 11.3% in Italy and 17.7% in Spain.

After an already good Q1 (real GDP up +0.6%), economic growth was probably also strong in Q2. The outlook is very positive for the rest of the year, even though it will perhaps be difficult to maintain the same level of positive surprise. After the political risk theme (which featured prominently in H1), it is probably the ECB's attitude that will be the subject of close attention over the next few months.

United States >

High level of job creations in June. Total nonfarm payroll employment increased by 222,000 in June (compared to 179,000 expected and after 152,000 in May). The unemployment rate rose fractionally (4.4% after 4.3% in May), due in part to the increase in the participation rate (62.8% after 62.7%). Over the year, average hourly earnings have risen by 2.5% (compared to 2.4%) and the average workweek rose to 34.5 hours (from 34.4). Furthermore, **ISM indicators** remain high (57.8 for the ISM manufacturing index and 57.4 for the ISM non-manufacturing index).

These figures mitigate the impression that the US economy was (relatively) week in the first half of the year. The expansion cycle is continuing and the labour market is going against the forecasts of a deceleration, but without generating major inflationary pressures. This can partly be explained by the fact that surplus capacity remains, despite the low unemployment rate (the participation rate is still lower than it was before the crisis), while structural shifts in the labour market also probably play a role in the wage-moderation trend.

Monetary policy

United States>

The minutes of the June committee meeting indicate that FOMC members wish to continue reducing the accommodative monetary policy, despite the recent slowdown in underlying inflation.

For the Fed, the next stage is likely to be the announcement of the triggering of a reduction in the balance sheet. The healthy labour market is likely to prompt it to continue with fed fund hikes thereafter. Market expectations remain too pessimistic in relation to the future path of fed funds.

Financial markets

Fixed-income

Sharp rise in yields in Germany, particularly on the 5-year maturity. The German 5-year yield rose 14 bp over the week to end at -0.08% (it is necessary to go back to November 2015 to find it in positive territory). The FOMC minutes have had an impact on fed fund expectations, with the markets now expecting a rate hike in December and another one in 2018. The US 2-year yield continued to rise and the US 10-year yield ended the week at 2.39%. In the eurozone, sovereign spreads were stable, or even tightened on the 5-year maturity.

See editorial.

Foreign exchange

The US dollar was up against virtually all currencies, particularly after the publication of the FOMC minutes. Currencies with a high current account deficit have depreciated substantially: the South African rand and the Turkish lira lost 2.9% and 3.2% respectively against the US dollar over the week. The EUR/USD exchange rate remained relatively stable at around 1.14. Note that the yen's effective exchange rate has returned to its lowest levels for the year.

The dollar's effective exchange rate has lost around 5% since the beginning of 2017. This weakening of the dollar is largely due to the fact that Donald Trump appears to be unable to keep a number of his campaign promises (tax reform, protectionist measures). Accordingly, it is the Mexican peso that appreciated the most against the US dollar (+13% over the year). That said, this disappointment has now been digested by the markets and it is mainly against the euro and Canadian dollar, whose central banks are moving towards gradually less accommodative policies, that the US dollar looks set to lose ground over the next few months.

The euro is expected to continue to strengthen over the coming quarters. The main reason why the euro depreciated in 2014/2015 and has remained low subsequently is the huge portfolio investment outflows caused by rates that are too low (or even negative) in the eurozone. The recalibration of the ECB's policy is likely to reverse this trend, with flows becoming positive again. This and the very high current account surplus (nearly €400 bn) is expected to contribute to the euro's appreciation. As a reminder, in 2014, the Fed's tapering coincided with a sharp appreciation of the US dollar.

Credit

Cash credit indices proved resilient to the sharp rise in yields in Germany, particularly on the 5-year maturity. The Euro IG index tightened by 5bp to end at 98bp, or only 10bp above the lowest level in the last five years. The Euro HY index widened by 14bp to end at 290bp. However, the spread of HY issuers had tightened substantially since the beginning of the year reaching, at the end of June, the lowest level recorded since the Lehmann crisis.

The environment remains buoyant for credit in the eurozone: (1) The fundamentals of eurozone companies remain robust. Issuers are benefiting from a better economic environment which resulted in a significant improvement in the growth of revenues and profits in Q1. In addition, the contained growth of debt, despite very attractive financing conditions, contributed to the reduction/ stabilisation of European issuers' debt leverage. (2) Technical factors are positive thanks to the CSPP, the ECB's corporate debt purchase programme. (3) However, valuations are stretched: the potential for spread tightening is limited. Lastly, we favour carry strategies in this market (BB, BBB, subordinated financial debt).

Equity

Equities had a calm start to the third quarter after having already made solid gains since the beginning of the year: the MSCI World in USD has risen almost 10% since 1 January. Emerging markets are leading the pack, with gains of over 16%. The eurozone (MSCI EMU) and the United States (S&P500) are close to 8%, ahead of Japan (TOPIX) at 6.5%. UK large caps (FTSE100) are bringing up the rear at just +3%.

The second half of the year has some potential traps, primarily during the autumn: 1) communication from the Fed and the ECB in September, both of which are expected to announce a shift towards less accommodative monetary policy; 2) the end of the National Congress of the Communist Party of China, which could also question the authorities' intention to concentrate on more structural measures rather than economic ones; 3) the end of favourable base effects; year-to-year earnings comparisons will become tougher for companies starting from the end of the third quarter. However in the meantime, second-quarter corporate earnings releases should be solid and conducive to good equity market performance.

Key upcoming events

Economic indicators

China : CPI is expected to increase in June. **UK:** Unemployment rate should remain stable May.

Date	Country	Upcoming macroeconomic data	Consensus	Prior
July 10	China	CPI. YoY. June	1.6%	1.5%
July 12	UK	Unemployment rate. May	4.6%	4.6%
	Eurozone	Industrial production. MoM. May	0.3%	0.5%
	India	Industrial production. MoM. May	3,0%	3.1%
July 13	US	PPI. MoM. June	-0.1%	0,0%
July 14	Eurozone	Trade balance. May	-	€ 17.9 Mds
	US	CPI. YoY. June	1.8%	1.9%

Source: Amundi Strategy

Auctions

Date	Country	Auctions of European sovereign debt [maturity, amount (if available)]
July 10	France	Short-term, € 6.4 Bn
	Germany	Short-term, € 2 Bn
July 12	Germany	Long-term, € 5 Bn
	Greece	Short-term, € 625 M

Source: Bloomberg, Amundi Strategy

Key events

Date	Upcoming monetary policy committee meetings
July 20, 2017	European Central Bank (ECB)
	Bank of Japan (BoJ)
July 26, 2017	Federal Reserve (Fed)
August 3, 2017	Bank of England (BoE)

Date	Upcoming important events
24 September 2017	Germany - General Election

Source: Amundi Strategy

Market snapshot

Equity markets	07/07/2017	Over 1 week	Over 1 month	Ytd
S&P 500	2410	-0.6%	-1.0%	7.6%
Eurostoxx 50	3458	0.5%	-2.5%	5.1%
CAC 40	5142	0.4%	-2.3%	5.8%
Dax 30	12362	0.3%	-2.4%	7.7%
Nikkei 225	19929	-0.5%	-0.3%	4.3%
MSCI Emerging Markets (close -1D)	1006	-0.5%	-0.9%	16.7%
Commodities - Volatility	**07/07/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
Crude Oil (Brent, $/barrel)	47	-1.2%	-1.5%	-16.6%
Gold ($/ounce)	1216	-2.0%	-5.5%	5.6%
VIX	12	0.8	1.6	-2.0
FX markets	**07/07/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
EUR/USD	1.14	-0.3%	1.2%	8.4%
USD/JPY	114	1.4%	3.7%	-2.6%
EUR/GBP	0.88	0.8%	1.8%	3.6%
EUR/CHF	1.10	0.3%	1.1%	2.5%
Fixed Income markets	**07/07/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
EONIA	-0.36	-1 bp	-	-3 bp
Euribor 3M	-0.33	-	--	-1 bp
Libor USD 3M	1.30	-	+8 bp	+31 bp
2Y yield (Germany)	-0.59	-2 bp	+13 bp	+18 bp
10Y yield (Germany)	0.57	+11 bp	+30 bp	+36 bp
2Y yield (US)	1.40	+2 bp	+9 bp	+21 bp
10Y yield (US)	2.39	+9 bp	+22 bp	-6 bp
Eurozone Sovereigns 10Y spreads vs Germany	**07/07/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
France	+37 bp	+2 bp	-6 bp	-11 bp
Austria	+24 bp	-1 bp	-4 bp	+2 bp
Netherlands	+20 bp	+1 bp	-2 bp	+5 bp
Finland	+4 bp	-	-2 bp	-10 bp
Belgium	+36 bp	+3 bp	-	+4 bp
Ireland	+40 bp	-3 bp	-7 bp	-14 bp
Portugal	+257 bp	+1 bp	-26 bp	-98 bp
Spain	+115 bp	+8 bp	-15 bp	-3 bp
Italy	+177 bp	+8 bp	-26 bp	+16 bp
Credit markets	**07/07/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
Itraxx Main	+57 bp	+1 bp	-4 bp	-15 bp
Itraxx Crossover	+258 bp	+11 bp	+9 bp	-31 bp
Itraxx Financials Senior	+55 bp	+2 bp	-14 bp	-39 bp

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