Amundi
ASSET MANAGEMENT

Cross asset investment strategy

Research,Strategy and Analysis

WEEKLY

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Highlights of the week

- **Markets:** European sovereign spreads down sharply; German and US rates climbing and European currencies up after the first round of French presidential elections. Equity Markets and the euro and dollar credit markets performed this week.
- **Europe:** Inflation came back with a roar in March. Growth remained strong in Spain, but disappointed somewhat in France and in the UK.
- **US:** GDP growth well below consensus in Q1.

Key focus

How will the Fed react to Trump's tax policy?

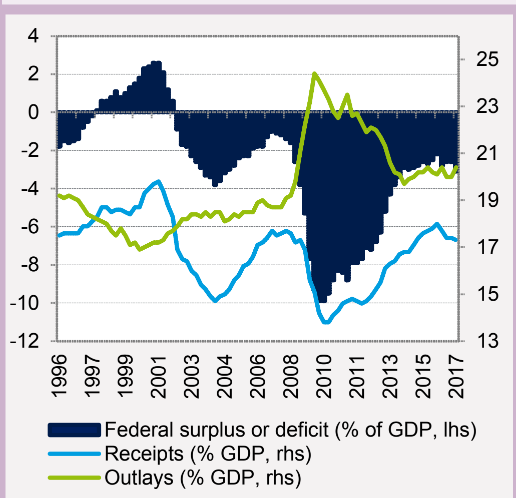
The election of Donald Trump has generated high expectations in terms of fiscal policy.

Household and business surveys have improved considerably since Trump's election. The promised tax cuts were expected immediately, which is more than the markets should have hoped for. At first, the financial markets progressed in line with "animal spirits": equities, long-term interest rates and the dollar all climbed simultaneously.

On 26 April, Trump officially endorsed the outlines of his tax plan.

As expected, he proposes to make massive cuts to **individual income taxes** (reducing the number of brackets, while lowering the rate of the top bracket from 39.6% to 35%, doubling the main deductions, giving tax credits to families, and eliminating the inheritance tax) and to **corporate income taxes** (lowering the tax rate from 35% to 15%, moving to a "territorial" tax system, and temporarily reducing taxes for repatriation of foreign-earned profits). **But what chance does his plan have of succeeding?** You will recall that a portion of the partial repeal of Obamacare that he was proposing was rejected by Republicans and, furthermore, that the so-called “border tax adjustment”, the main protectionist measure developed by Republicans in the House of Representatives, was dropped after the Senate opposed it. Yet these were the top two measures likely to fund the tax cuts.

US Federal deficit



Source: Datastream, Amundi Research

Congress’ approval is far from secured

As Treasury Secretary Steven Mnuchin points out, the tax cuts will be largely self-funded, thanks to the resulting growth. Yet this is an artefact linked to an excessively optimistic growth scenario (>3%). And the Congressional Budget Office (CBO), which must assess the impact of these tax cuts on the deficit before they can be voted on, will certainly not retain the same scenario. So, it will be difficult to convince Republicans to adopt a bill that will add so much to the debt, while the US economy is not in a phase of the cycle that requires a stimulus plan (the country is already close to full employment). And of course, the tax cuts must be approved by the Senate, where Republicans hold just 52 out of 100 seats. This slight majority precludes traditional budgetary procedure, unless Democrats support the measures, which is unlikely. In fact, it takes 60% of votes to avoid systematic obstruction (filibustering) by the Democrats. Nonetheless, it is possible to opt for a "budget reconciliation" procedure: this can be used to pass a bill with a simple majority, as long as the tax cuts are temporary (up to 10 years, in theory). That's how George W. Bush got his tax cuts voted on in 2001 and 2003.

Ultimately, without funding, the tax cuts will very probably be adjusted downward. Whatever happens, budgetary procedure is lengthy, and just getting started, so it is unlikely that Congress will vote on it before autumn. **The proposed budget expansion could well send inflation expectations into a skid, but later in the year, when a compromise is in sight. It's still too soon for the Fed to worry**.

The week at a glance

> Economic indicators

Europe > **Inflation came back with a roar in March.** The Harmonised Index of Consumer Prices (HICP) picked up again in April to 1.9% (from 1.5% in March). Core inflation (i.e., ex-energy and ex-food) also accelerated, to 1.2% (from 0.7% in March). **The business climate continued to improve**. The European Commission's Economic Sentiment indicator rose further, to 109.6 (vs. 108.1 forecast and vs. 108 in March), a 10-year high. The German IFO continued to pick up, to 112.9 (vs. 112.5 forecast and after 112.4 in March). **Growth remained strong in Spain, but disappointed somewhat in France and in the UK**. Spain's GDP rose by 0.8% in Q1 (vs. +0.7% forecast and after +0.7% in Q4 2016). France's GDP inched up just 0.3% (vs. +0.4% forecast and after +0.5% in Q4 2016), dragged down by poor household consumption and export figures, although there was a clear improvement in investment (both business and household residential).Finally, the UK's GDP grew by only 0.3% in Q1 (versus +0.4% expected and after +0.7% in Q4 2016).

A sustained acceleration in core inflation would mark a major shift for the markets, as that would probably lead to a change in the ECB's stance. That said, a single higher-than-expected monthly figure is not enough to change things. The April increase is very likely due to technical factors, which are common in spring (due to calendar shifts from year to year, and the Easter holiday). However, another high figure in May would raise eyebrows. As for growth, in reaction to the recent improvement in European indicators and the receding in political risk, we have raised our euro zone GDP growth forecast to 1.6% from 1.5% for 2017 and to 1.5% from 1.3% for 2018.

United States > **GDP growth well below consensus in Q1.** US GDP advanced 0.7% in Q1 (annualized figure, vs consensus at 1.2% and Q4 growth at 2.1%). Personal consumption increased by only +0.3%, investment by +10.4% and government consumption decreased by -1.7%. International trade brought a slightly positive contribution of +0.1 pp while inventories brought a negative contribution of -0.9 pp.

US quarterly growth figures are very volatile, especially for Q1, and often extensively revised. Due to rather disappointing figures in the first months of the year, we were expecting a relatively weak Q1 GDP growth. This said, the solid household confidence points to a recovery of private consumption in the second quarter. This outlook, as well as vigorous employment cost in Q1 (+0.8% compared to the previous quarter, vs. 0.6% expected by the markets), both play in favour of the Fed not revising its calendar of fed funds hikes.

Japan> **The March reading of industrial production figures raises a hint of concern.** Output fell 2.1% m/m, though a contraction was widely expected. In the release of the February statistics, the Ministry of Economy, Trade and Industry had already suggested that manufacturing output would fall 2%. What surprised the market was the inventories, which increased for the fourth consecutive month to a six-month high. Manufacturers are planning to boost production by a massive 8.9% in April. However unsold goods could spoil such optimism.

Producers reduced output in order to sweep unsold goods out of shelves. Yet shipments also plunged 1.1% in March. The rise in undesired inventories stems from stagnant consumer spending. Inventories of durable consumer goods surged 10.8% m/m in March due to muted sales of home appliances and computers. Retailers expected freshmen and new employees would actively purchase equipment ahead of new fiscal year. In fact, major general merchandisers and the three biggest convenience store operators decided to reduce sales price of daily necessities on the back of long-lasting stagnancy in consumer expenditure. As a consequence, CPI excluding foods and energy fell 0.3% y/y in March, for the second consecutive month of decline, while core CPI (CPI excluding fresh foods), on which the Bank of Japan and the market had laid emphasis, rose 0.2% y/y. According to the latest estimate by the BOJ, core CPI will rise 1.4% y/y in FY2017 starting April, in contrast to the market consensus of 0.83%

> Monetary policy

ECB > **Business as usual at the Governing Council.** The introductory statement has changed very little. Mario Draghi was reassuring on the economic outlook, saying that the downside risks had dissipated a bit more. Still, he reiterated that the pace of inflation was too weak to consider taking any exceptional monetary easing measures off the table in the near term.

For the ECB, there is clearly no need to rush forward, given the weakness of core inflation. However, we think that the ECB should announce a reduction in QE at the end of the year.

Riksbank >

The Sweden's central bank (Riksbank) kept the repo rate unchanged at -0.5%, as expected. But the central bank set a dovish tone: i) in announcing it is going to extend its QE program to H2 2017 by the amount of SEK 15bn; and ii) in indicating that the repo rate may not be raised until mid-2018. It is important to note that the decision to extend the QE program was not unanimous: three out of six board members ledged reservations against it.

The Riksbank has given clear indications that it is tracking the ECB's MP decisions and thus it is very likely that the Riksbank may keep its dovish monetary policy stance as long as the ECB does. Currently, low inflation pressures and the view that wage costs in particular "will rise more slowly than expected" gives room for the expansionary monetary policy stance, despite strong economic growth. However, if this course reverses itself, the Riksbank will be under pressure to start tightening monetary policy. All in all, in the short/medium run, inflation figures should be watched very closely.

Russia>

The CBR has reduced its key rate from 50 bp to 9.25%.

This decision is in line with the sharp reduction in inflation, which at the end of April stood at 4.2-4.3% in ga, just above the CBR target set at 4%. The appreciation of the ruble is mentioned as the main factor in the deceleration of inflation over the last two months. The CBR indicates that its choice was also motivated by the anchoring of inflation expectations. However, the CBR reports that the upside risks, especially on expectations, are not nil due to a possible recovery in food prices. The CBR indicated that it would remain vigilant. To the extent that the recovery of activity seems to materialize, the urgency to lower rates is not as strong. But, if oil prices stay at sustained higher levels (above US $ 50 per barrel), the CBR may issue new further declines to its next 16 June.

Turkey >

Against all market expectations, the CBRT increased its marginal liquidity ratio by 50bp to 12.25% and kept its other key rates unchanged. It is interesting to note that the press release no longer mentions the scenario of a prolonged increase in inflation, no doubt considering that inflation reached a high point in March with 11.3%. However, it is mentioned that if necessary, the CBRT will extend its monetary tightening schedule in order to avoid any worsening of projected inflation. The average cost of credit is now 11.5%.

Despite the unconventional aspect of the CBRT's policy, the markets have taken the measure pretty well. With downward pressures on the Turkish lira diminished, there is less of an upside risk on inflation. However, price volatility on food products could continue to push inflation up. While we do not expect an increase in the key interest rate in June, we do think another rise in the marginal liquidity rate is more than likely in an environment where growth is still sustained. This would, in addition, let the CBRT demonstrate its independence from the Government.

> Financial markets

Fixed-income

European sovereign spreads down sharply and German and US rates climbing after the first round of French presidential elections. The 10-year spread between France and Germany narrowed from 69 to 52 bp. German and US 10-year rates gained 8 and 7 bp for the week, to close at 0.33 and 2.31%, respectively**.**

Sovereign spreads were reduced as the risks of a eurosceptic government in France receded. However, they have not returned to their levels of six months ago, and we are probably going to move into a period of higher sovereign spreads. In fact, the upcoming Italian elections are still in focus, as is the tapering of the ECB's sovereign bond buying programme.

Foreign exchange

European currencies (EUR, PLN, CZK, HUF) up after the first round of French presidential elections. EUR/USD is back around 1.09. The yen is down with the dissipation of risk aversion; USD/JPY closed out the week at 112. Oil currencies suffered when oil prices fell again (-0.4% over the week).

We uphold the idea that the EUR/USD exchange rate will be higher than current levels at year's end. The Trump administration's announcements on tax reform have had very little impact on the dollar, as many questions remain unanswered (see Editorial).

Credit

The euro and dollar credit markets performed this week. It should be noted that the euro credit has surpassed the dollar credit in recent weeks.

US: the surge in optimism after Trump's victory has waned, due to disappointing real figures and the challenges of implementing the ambitious tax reform. In mid-March market participants have begun to price in weaker growth for the US economy. The environment nonetheless remains favourable to the credit markets. The Fed's monetary policy is likely to remain accommodating. The Fed has not included fiscal and tax stimulus assumptions in its growth projections and is still flagging three rate hikes for 2017. The planets are aligned on the credit markets, with stable economic growth, accommodating monetary policy, and lower (though still at an all-time high) corporate debt. We nonetheless remain cautious on lower-rated US HY issuers.

Euro zone: Mario Draghi reiterated that the upturn in the Eurozone economy was continuing. But he pointed out that highly accommodating monetary policy remains essential for revising underlying inflationary pressures. The lifting of political uncertainties will have a positive impact on spreads. But questions over whether QE will remain in place are likely to come to the fore in the second half and could stoke volatility. Our scenario assumes that QE will continue into 2018, which is good news for the credit market. The increase in European corporate debt leverage is still under control at this point in the cycle. On the euro market we are overweighting issuers that offer attractive yields.

Equity

A sigh of relief. The outcome of the first round of voting in the French presidential election triggered a market rally, with the CAC 40 gaining 4.1% and the MSCI Euro Zone up 3.6%. The strength of the rally was driven, among others, by the unwinding of hedges after the end of the worst-case scenario, that would have seen the facing of the two Eurosceptic candidates. Such a scenario would have likely fuel capital outflows and undermine banks; hence their relief rally the day after, with the MSCI EMU Banks up 7.2%.

The rally came amidst very heavy volumes. Almost €8.8bn was traded on the CAC 40 Monday, vs. an average of €3.3bn since the end of 2015. While volumes have receded somewhat since then, it is clear that once the elections are behind us, euro zone equities and French ones in particular are likely to win over an increasingly broad spectrum of investors, as their combination of valuation x earnings prospects look attractive compared to the US.

Key upcoming events

Economic indicators

US : MoM Core PCE inflation is expected to be negative in March. **Eurozone**: retail sales should be stable in March.

Date	Country	Upcoming macroeconomic data	Consensus	Prior
May 1	US	Core PCE. MoM. March	-0.2%	0.1%
	US	Manufacturing ISM. April	56.5	57.2
May 2	Inde	Manufacturing Nikkei PMI. April		52.5
	Chine	Manufacturing PMI Caixin. April	51.3	52.2
	Brazil	Manufacturing Markit PMI. April		49.6
May 3	Eurozone	GDP. QoQ. Q1	0.5%	0.4%
	Brazil	Industrial production. YoY. March	2.2%	-0.8%
	US	Non-Manufacturing ISM. April	55.9	55.2
May 4	Eurozone	Retail Sales.MoM. March	0.0%	0.7%
May 5	US	Change in nonfarm payrolls. November	190 K	89 K

Source: Amundi Strategy

Auctions

Date	Country	Auctions of European sovereign debt [maturity, amount (if available)]
May 2	France	Short-term, € 6.2 Bn
May 3	Germany	10 years, € 3 Bn
May 4	France	Long-term, amounts not available on Friday
	Spain	Long-term, amounts not available on Friday

Source: Bloomberg, Amundi Strategy

Key events

Date	Upcoming monetary policy committee meetings
May 3, 2017	Federal Reserve (Fed)
May 11, 2017	Bank of England (BoE)
June 8, 2017	European Central Bank (ECB)
June 16, 2017	Bank of Japan (BoJ)

Date	Upcoming important events
April 29,2017	European Council on Brexit
May 7, 2017	France - Second round Presidential election
June 8, 2017	United Kingdom - Parliamentary Elections
June 11, 2017	France - First round of Legislative Elections
June 18, 2017	France - Second round of Legislative Elections
24 September 2017	Germany - General Election

Source: Amundi Strategy

Market snapshot

Equity markets	28/04/2017	Over 1 week	Over 1 month	Ytd
S&P 500	2389	1.7%	1.3%	6.7%
Eurostoxx 50	3567	3.7%	2.9%	8.4%
CAC 40	5279	4.4%	4.6%	8.6%
Dax 30	12444	3.3%	2.4%	8.4%
Nikkei 225	19197	3.1%	0.0%	0.4%
MSCI Emerging Markets (close -1D)	980	1.9%	1.0%	13.6%
Commodities - Volatility	**28/04/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
Crude Oil (Brent, $/barrel)	52	-0.4%	0.8%	-8.9%
Gold ($/ounce)	1266	-1.4%	1.1%	9.8%
VIX	10	-4.3	-1.2	-3.7
FX markets	**28/04/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
EUR/USD	1.09	1.7%	0.9%	3.7%
USD/JPY	112	2.3%	0.4%	-4.6%
EUR/GBP	0.84	0.8%	-2.8%	-1.0%
EUR/CHF	1.08	1.3%	0.9%	1.0%
Fixed Income markets	**28/04/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
EONIA	-0.36	--	--	-3 bp
Euribor 3M	-0.33	-	-	-1 bp
Libor USD 3M	1.17	+2 bp	+2 bp	+17 bp
2Y yield (Germany)	-0.72	+8 bp	-2 bp	+5 bp
10Y yield (Germany)	0.33	+8 bp	-6 bp	+12 bp
2Y yield (US)	1.28	+10 bp	-2 bp	+9 bp
10Y yield (US)	2.31	+7 bp	-10 bp	-13 bp
Eurozone Sovereigns 10Y spreads vs Germany	**28/04/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
France	+52 bp	-17 bp	-5 bp	+4 bp
Austria	+29 bp	-5 bp	+9 bp	+7 bp
Netherlands	+23 bp	-4 bp	-2 bp	+8 bp
Finland	+9 bp	-5 bp	-1 bp	-5 bp
Belgium	+47 bp	-9 bp	-1 bp	+14 bp
Ireland	+53 bp	-16 bp	-10 bp	-1 bp
Portugal	+321 bp	-28 bp	-47 bp	-34 bp
Spain	+132 bp	-12 bp	+3 bp	+14 bp
Italy	+195 bp	-6 bp	+17 bp	+34 bp
Credit markets	**28/04/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
Itraxx Main	+67 bp	-8 bp	-7 bp	-5 bp
Itraxx Crossover	+266 bp	-25 bp	-24 bp	-23 bp
Itraxx Financials Senior	+75 bp	-16 bp	-12 bp	-19 bp

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