Amundi
ASSET MANAGEMENT

Cross asset investment strategy

Research,Strategy and Analysis

WEEKLY

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Highlights of the week

- **Markets:** sovereign bond markets without trend; the pound is losing ground, and is back to its lowest level for two months vs the euro. Credit markets were supported by positive sentiment; equity markets still calm.
- **Eurozone:** Business climate indicators continue to provide positive surprises.
- **US:** home sales slightly disappointing.

Key focus

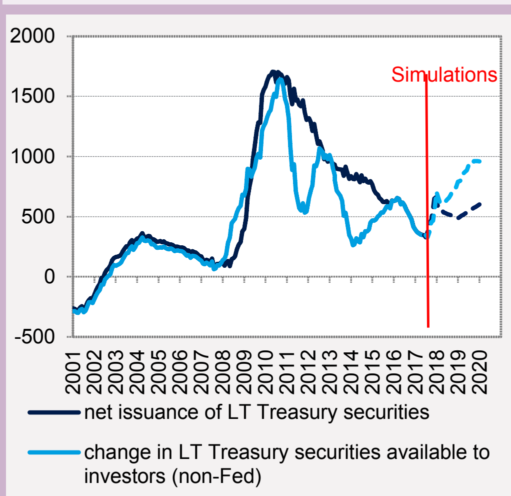
Fed: the difficult task of shrinking the balance sheet

Certainly, history will show that it is much easier for the major central banks to put quantitative easing measures in place than to remove them. The minutes of the FOMC meeting that took place on 3 May showed that discussions on the reduction of the Fed's balance sheet had made the least headway. The issue is whether and how to stop reinvesting the maturing securities (Treasury securities and MBS) that the Fed holds. The system being considered would introduce "caps" on the dollar amounts of Treasury and agency securities that would be allowed to run off each month (ie that would not be reinvested). These "caps" would be revalued upward every three months.

For the FOMC, beginning non-reinvestments with limited quantities would have the advantage of avoiding spikes in bond yields. While the Fed's asset purchases had reduced the supply of Treasury securities available for non-Fed investors, the non-reinvestment of maturing securities held by the Fed will increase the supply of Treasury securities available for investors. Recently, the Fed's research documents have shown that the impact of the Fed's balance sheet reduction on the term premium would be very gradual: according to the Fed's economists, the three Quantitative Easing operations and the Operation Twist lowered the 10-year yield by 100 bp, and the gradual reduction of the balance sheet would attenuate this impact to 70 bp by end 2018.

Imagine, for example, that the FOMC opts for this mechanism when they meet in September, and that the non-reinvestment begins in October, with a non-reinvestment cap of $15 bn per month, revised upward to $30 bn starting in January, then $45bn starting in April and that the non-reinvestment be total starting in Q3 2018 and until the balance sheet is normalised. **In this case, the non-Fed investors should absorb around $ 800 bn long-term Treasury securities in 2018 and more than $ 950 bn in 2019, what would be back to 2013 quantities (see the opposite chart).**

Net issuance of long-term Treasury securities (12 m. rolling sum, $bn)



Source: Datastream, Amundi Research

1) The simulations above make the assumption that half of the non-reinvesments would concern Treasury securities (and the other half MBS). 2) The deficit forecasts are taken from the CBO. 3) We make here the assumption that the net issuance of T-bills would converge to zero.

FOMC members would not alter this mechanism for reducing the balance sheet as long as there were no "material deterioration in the economic outlook." Not particularly anxious on economic growth, the members are asking more questions about inflation, with the recent decline in underlying inflation after a two-year upward trend, but also that of market inflation expectations.

Thereafter, the start of non-reinvestment of maturing securities will raise the issue of substitutability between fed funds increases and balance sheet reduction. A note from the Fed of Kansas City finds that a $675 bn reduction in the Fed's balance sheet over a two-year horizon is about equivalent to a 25 basis point hike in the funds rate. New York Fed Chair Bill Dudley said in April: "*If we start to normalize the balance sheet, that's a substitute for short-term rate hikes, and we might actually decide at the same time to take a little pause in terms of raising short-term interest rates.*" The opportunistic Fed will not let it pass that the markets are pricing June's rate increase. But things will get more complicated after that, especially if the outlook for the fiscal stimulus considered earlier does not materialise…

The week at a glance

> Other events

Oil>

OPEC and other producers have extended their agreement to reduce production by 9 months. This agreement (to which notably Russia, among non-OPEC producers, is party) has been in force since 1 January 2017 and has been extended until end-March 2018. It involves a reduction in production of 1.8 million barrels per day, i.e. around 2% of global production.

This agreement was expected and, in the absence of decisions or statements pointing to sharper reductions, the price of oil reacted by declining. The reduction in the production of OPEC and its partners is an important support factor for the crude oil price, but it is necessary to remember that there is a major opposing force: the very rapid progress made by US shale gas production. Each time prices rise, new US wells become profitable, hampering in turn the rise in prices.

China - Rating>

On 24 May 2017, Moody's downgraded China's Aa3 sovereign rating (which had a negative outlook) by one notch, to A1 with a stable outlook. The downgrade was motivated by the broad-based rise in leverage and consequent increase in contingent liabilities for the government. The agency expects the erosion of China's credit profile to be gradual, and possibly contained with deepening structural reforms.

We are not surprised by this downgrade, since we considered a 'Aa' rating too high for the current fundamentals of the Chinese economy and the evolution of credit quality. The rapid growth in economy-wide debt against a slower GDP backdrop is a cause for concern.

China - FX>

The PBoC is going to change the way it calculates the CNY's daily reference rate against the USD, according to a government statement published on Friday. Under the current regime, the USD/CNY fixing mechanism refers to two parameters: i) USD/CNY spot closing rate at 4:30 pm (local time) on the previous day and ii) changes in basket currencies. The new method is going to include a "counter-cyclical adjustment factor", which is likely to reduce exchange rate volatility.

We believe that while such an adjustment is not a fundamental change in the methodology used to determine the CNY fixing per se, it gives a clear signal that the PBoC is worried about maintaining currency stability as such an action can be an attempt to reduce the impact of market forces on the yuan. It does raise questions whether the authorities are not undermining efforts to make the currency more freely traded.

Brazil - Politics >

Political uncertainty remains high and the week was marked by violent demonstrations against President Michel Temer's government in Brasilia. In particular, demonstrators broke into several ministries (including the Ministry of Finance, Mining and Energy), causing widespread damage and, more specifically, set fire to the Ministry of Agriculture. Facing such a chaotic situation, the president Michel Temer decided to call in the army to ensure "the Guarantee of Law and Order," which is regulated by the Federal Constitution. This means that the army can operate with police power until the president's decree is revoked, which was firstly scheduled for 31 May. But as the situation rapidly returned to normal, the president revoked the decree the following day. Such action was considered too extreme by many politicians and especially by the opposition, which accused the government of returning the country to times of dictatorship.

It is important to note that i) such a decree has already been used in other situations in Brazil, for example, during the pacification of favelas in Rio, in 2014/2015 and ii) the military intervention was limited to Brasilia and had the objective of defending public assets (not prohibit manifestations or attack demonstrators – a coup is out of question).

Regarding the president's situation, it remains extremely fragile and might be unsustainable. Even though Temer managed to gain some time given that the Supreme Court accepted that the audio tapes should be technically analysed by the Federal Police – this might take about 30 days to be concluded – there are many doubts about his governability. Investigations against the president are continuing and there is no certainty that the president will be able to retain the support of his major political allies (DEM and PSDB). It seems that the parties have adopted a "wait and see mode" until the trial at the Supreme Court of Elections (TSE) scheduled for 6-8 June, to decide whether they will continue to support the president or not. If it is proven that the Dilma-Temer 2014 electoral campaign was financed with money from corruption, the justice will cancel the 2014 elections. In such a case, Temer will have to step down straight away. Before last week's scandal, this result was deemed to be highly improbable. But given recent events this outcome has become quite likely. One thing is very clear: uncertainty is high and anything can happen over the coming days. Specifically, events disclosed over the next few days will be key for the TSE trial.

Brazil - Rating > **On 22 May 2017, Standard & Poor's placed its BB credit rating for Brazil on CreditWatch with negative implications amid an uncertain political backdrop.** This move implies that the rating could be downgraded over the next three months in the case of worsening political dynamics. Should the allegations for corruption against President Michel Temer prove to be correct and should the President be impeached, a complicated transition process could ensue ahead of the 2018 presidential elections.

We are not surprised by this move as we believe that this high political uncertainty could be detrimental to overcoming the increasingly important fiscal and economic challenges the country faces (such as growing primary deficits and debt level). Prolonged political turmoil could result in delaying the upcoming vote on pension reform, which is crucial for fiscal sustainability.

Economic indicators

Eurozone > **Business climate indicators continue to provide positive surprises.** The Flash estimate of the May PMI Composite index stood at 56.8 (unchanged vs. April, and vs. 56.6 expected). In Germany, the IFO index (industrial confidence) stood at 114.6 (vs. 113.1 expected, following 113 in April) or its highest level since 1991. En France, Insee's industrial confidence index stood at 109 (unchanged vs. April, and vs.108 expected). Moreover, German Q1 GDP growth was confirmed at +0.6%, with details of its components showing a sharp rise in investment (+1.2% in machines and equipment, +2.2% in construction). In Spain, Q1 GDP growth was confirmed at +0.8%, also with a healthy investment momentum (+3% for equipment, +1.1% for construction).

The European recovery is gaining in strength and quality (increase in investment). If we add to this the reduction in political risk, it is clear that the European horizon is improving for investors. There is still excess capacity in the labour markets. Consequently, wage-originated inflation is expected to remain moderate at least until next year.

US > **Home sales slightly disappointing.** New home sales fell in April (0.569 million vs. 0.610 million expected, following 0.642 million in March). Sales of existing homes were also slightly lower (5.57 million vs. 5.65 million expected, following 5.70 million in March).

The figures for home sales are very volatile and the slight disappointments in April do not undermine the recovery in the real estate market.

Japan > **Exports lost momentum in April.** Shipments from Japan rose by 7.4% y/y, compared to 12.0% in March and 11.3% in February. While y/y readings still show healthy gains, exports actually fell by 4.3% from their recent peak in February. The root cause was a sharp setback in shipments to Asia. From February to April, export volume to the region plunged 8.2%, which was partly offset by a 1% increase in shipments to the U.S. and the European Union.

Japanese exports are likely to show a y/y increase for a certain period of time, albeit at a more modest pace given the synchronised global economic expansion. The depreciation of the yen from a year earlier should boost export prices during the remainder of the year. Looking back, the yen was trading at 103 and 115 in the middle of last year against the US dollar and the euro, respectively. Now the quotes are 111 and 124. Nevertheless, we have witnessed slower vehicle sales in the U.S. and China. Moreover, foreign orders of semiconductor production equipment – one of the driving forces of exports in the last 12 months – have tapered off. In the meantime, the y/y compound increase in import volume was 5% in April as a rise in production prompted more imports of parts. Therefore, the contribution of net exports to GDP in the coming quarters is likely to be smaller than 0.6 percentage point in CY2016.

Financial markets

Fixed-income

Sovereign bond markets without trend over the week. The 10y. yield in Germany and in the US close out the week at respectively 0.34 and 2.24 %. Note that the German 10y. inflation break-even rate hit 1.10%, its lowest level since the US elections.

After the recent correction, long-term bond yields should start to rise again in the coming weeks.

Foreign exchange

The pound is losing ground, and is back to its lowest level for two months vs the euro, as the lead of the Tories over the Labour in opinion polls is shrinking. The EUR/USD is stable to 1.12. After the sharp fall of the Brazilian over the preceding week, the USD/BRL parity is stabilizing around 3.25 (see above).

We keep a negative bias on the pound, because of the worsening of the economic outlook (see above). However, we think that the euro will appreciate further vs the USD in the second part of the year.

Credit

Together with other risky assets, credit markets were supported by positive sentiment during the week: spreads generally traded slightly tighter from levels that had been reached towards the end of the previous week on the back of resurfacing political concerns. The primary market was quite active in Europe: just as the earnings season peaked, new issuance volumes were back to solid levels, after some weeks of subdued activity, confirming that the search for yield is still alive and kicking. Once again, US non-financial issuers were among the most active in EUR-denominated primary markets. US corporate bonds also saw their credit premium compressing, in line with the recovery of US equities on easing concerns over political risk.

The very latest numbers published by the ECB about its CSPP indicated weekly purchases of EUR 2 bn, which led the overall corporate bond portfolio to a cumulative volume of almost EUR 70 bn. The most recent purchase was higher than the previous weekly volumes, which ranged between EUR 1.2 bn and EUR 1.5 bn: to some extent, the primary market recovery probably also supported a more active ECB presence. After a very good earnings season, positive macro data continue to support the picture in the eurozone, while the most recent indications from Mario Draghi confirm a supportive monetary policy stance, despite the improved scenario. In this environment, we favour financials among EUR IG and non-financial EUR HY, while in the US, due to the different phase of the credit cycle and on the back of relative valuations, we prefer the IG area.

Equity

Equity markets still calm. First-quarter earnings are now practically final and very positive. We are looking at the best quarter in six years. Japan is in the lead with +28% over one year, followed by Europe at +23%. The United States is bringing up the rear. Energy and materials posted the top contributions. Revisions of earnings estimates are also the strongest since 2011.

The base effect is in full force on profits this quarter. Profits began to recover in the fourth quarter last year. That means annual comparisons will be facilitated through the end of the third quarter of 2017. This should help to sustain the equity markets until then. While American equities are priced especially high, capturing the risk premiums of the other equity markets compared to the US market is still a profitable strategy for now, even though summer is generally full of surprises.

Key upcoming events

Economic indicators

France : Manufacturing PMI should remain stable in May. **United States :** Unemployment rate is expected to increase in May.

Date	Country	Upcoming macroeconomic data	Consensus	Prior
May 30	France	GDP. QoQ. Q1	0.3%	0.3%
	Germany	CPI. GA. May	1.7%	2,0%
May 31	France	PPI. MoM. April	-	-0.5%
	Germany	Retail sales. YoY. April	0.2%	0.1%
June 1	France	Manufacturing PMI. May	54	54
	Brazil	GDP. QoQ. Q1	1.2%	-0.9%
	US	Manufacturing PMI. May	-	52.5
June 2	Eurozone	PPI. MoM. April	0.3%	-0.3%
	Brazil	Industrial production. YoY April	-	1.1%
	US	Unemployment rate. May	4.5%	4.4%

Source: Amundi Strategy

Auctions

Date	Country	Auctions of European sovereign debt [maturity, amount (if available)]
May 29	France	Short-term, € 6.8 Bn
May 30	Italy	Long-term, € 7.5 Bn
June 1	Spain	Long-term, amounts not available on Friday

Source: Bloomberg, Amundi Strategy

Key events

Date	Upcoming monetary policy committee meetings
June 8, 2017	European Central Bank (ECB)
June 14, 2017	Federal Reserve (Fed)
June 15, 2017	Bank of England (BoE)
June 16, 2017	Bank of Japan (BoJ)

Date	Upcoming important events
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	26/05/2017	Over 1 week	Over 1 month	Ytd
S&P 500	2415	1.4%	1.2%	7.9%
Eurostoxx 50	3568	-0.5%	-0.3%	8.4%
CAC 40	5319	-0.1%	0.6%	9.4%
Dax 30	12579	-0.5%	0.9%	9.6%
Nikkei 225	19687	0.5%	2.1%	3.0%
MSCI Emerging Markets (close -1D)	1015	1.9%	3.3%	17.7%
Commodities - Volatility	**26/05/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
Crude Oil (Brent, $/barrel)	52	-3.7%	-0.4%	-9.2%
Gold ($/ounce)	1266	0.8%	-0.2%	9.9%
VIX	10	-1.7	-0.5	-3.7
FX markets	**26/05/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
EUR/USD	1.12	-0.4%	2.4%	6.2%
USD/JPY	111	0.0%	0.2%	-4.9%
EUR/GBP	0.87	1.3%	2.7%	2.1%
EUR/CHF	1.09	-0.2%	0.5%	1.5%
Fixed Income markets	**26/05/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
EONIA	-0.37	--	--	-4 bp
Euribor 3M	-0.33	-	-	-1 bp
Libor USD 3M	1.20	+1 bp	+3 bp	+20 bp
2Y yield (Germany)	-0.68	--	+1 bp	+9 bp
10Y yield (Germany)	0.34	-3 bp	-2 bp	+13 bp
2Y yield (US)	1.29	+2 bp	+2 bp	+10 bp
10Y yield (US)	2.24	-	-6 bp	-20 bp
Eurozone Sovereigns 10Y spreads vs Germany	**26/05/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
France	+43 bp	-1 bp	-11 bp	-5 bp
Austria	+28 bp	--	-2 bp	+7 bp
Netherlands	+21 bp	-	-3 bp	+6 bp
Finland	+6 bp	-1 bp	-5 bp	-8 bp
Belgium	+36 bp	-3 bp	-12 bp	+3 bp
Ireland	+46 bp	-1 bp	-12 bp	-9 bp
Portugal	+284 bp	+3 bp	-38 bp	-72 bp
Spain	+120 bp	-1 bp	-15 bp	+2 bp
Italy	+177 bp	--	-20 bp	+16 bp
Credit markets	**26/05/2017**	**Over 1 week**	**Over 1 month**	**Ytd**
Itraxx Main	+62 bp	-2 bp	-5 bp	-10 bp
Itraxx Crossover	+251 bp	-3 bp	-18 bp	-38 bp
Itraxx Financials Senior	+67 bp	-2 bp	-7 bp	-26 bp

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