Monthly | Finalised at 13 January 2020

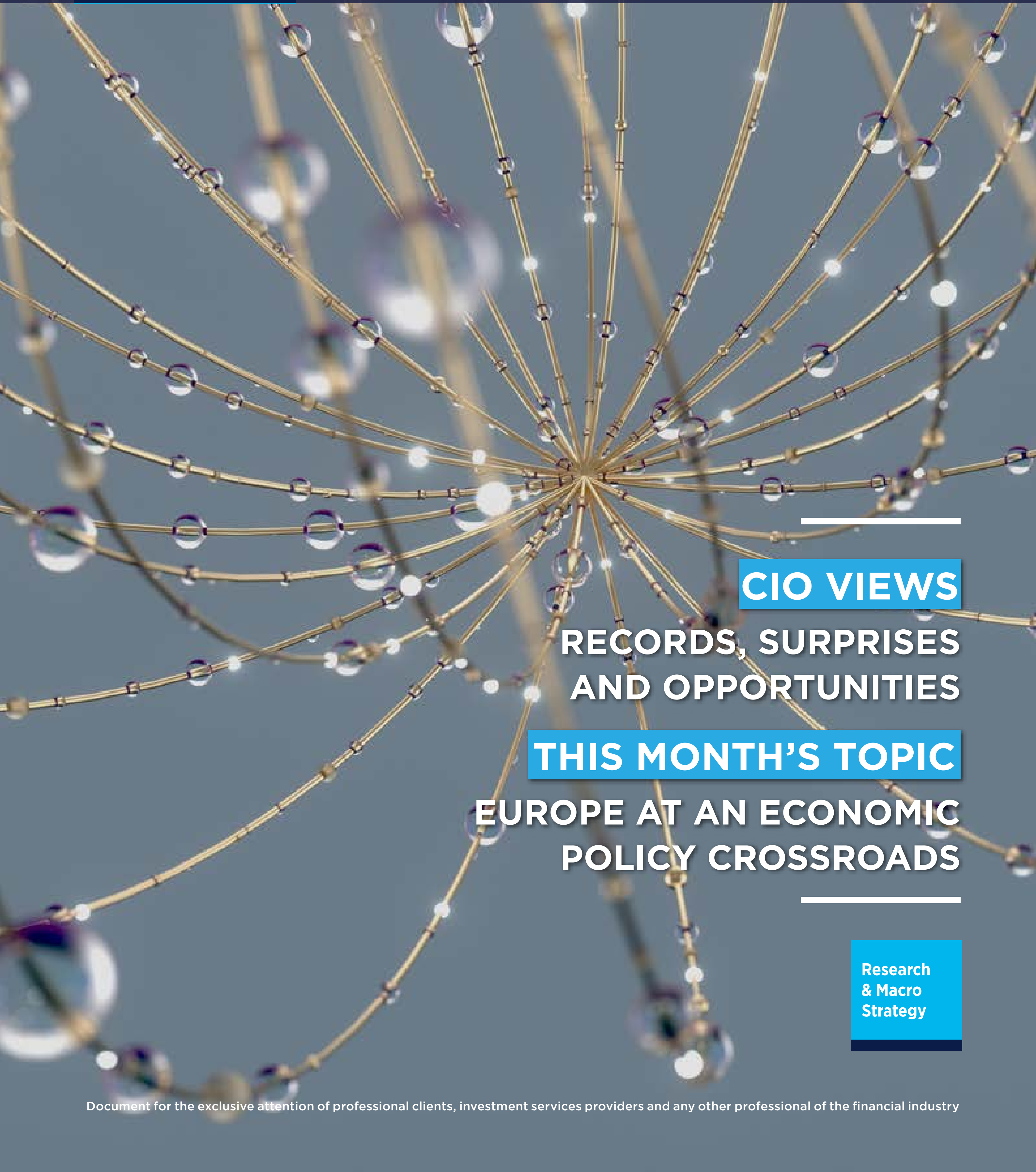
January 2020 #01

Confidence must be earned

Amundi ASSET MANAGEMENT

CROSS ASSET

INVESTMENT STRATEGY



CIO VIEWS

RECORDS, SURPRISES AND OPPORTUNITIES

THIS MONTH'S TOPIC

EUROPE AT AN ECONOMIC POLICY CROSSROADS

Research & Macro Strategy

CIO VIEWS

Records, surprises and opportunities

PASCAL BLANQUÉ, Group Chief Investment Officer
VINCENT MORTIER, Deputy Group Chief Investment Officer

As we approach the year-end, a look back over the past 12 months reminds us **how unconventional this year of records has been**. On the upside, equities rallied to historical highs in December and fixed income returns were also strong as bond yields fell. The combination of these trends enabled a traditional 50 bond/50 equity balanced portfolio for European to investors generate 15.5%[1], the best annual performance in the last two decades. However, 2019 also saw **some less exciting records** on economic and geopolitical fronts – a high world uncertainty index reading (Brexit, Trump impeachment process and trade war escalation). Debt skyrocketed, CO_2 emissions rose and social discontent erupted in many countries. **Overall, global growth decelerated**, inflation failed to reach Central Banks' (CB) targets and vulnerabilities continued to build. The **big disconnect** in market performance and a fragile economic environment is partially the result of re-rating of market valuations and the big shift in CB policies. Various forms of monetary accommodation have eased the financial conditions witnessed at the beginning of 2019.

Looking ahead, **"normalization" continues to be a word outside CB dictionaries**, although major institutions in Europe are becoming more uncomfortable about extreme measures. Tiering system for EU banks introduced by Draghi and Swedish Riksbank's decision to exit negative rates signal CBs' awareness of the damaging consequences of negative rates. **We see this awareness growing**, along with a debate on a more aggressive fiscal policy in Europe (infrastructure and green investing) and also in the US. **The scenario of fiscal easing is not fully priced in,** especially in core fixed income space and cyclical/value stocks. It could represent one of the main surprises next year that supports a bottoming out of core bond yields and rotation towards value sectors. **Another surprise could come from US**. We believe, President Trump will do '*whatever it takes*' to help the economy stay on track, but there is ambiguity over what outcome the markets prefer – a Trump re-election or a Democrat victory. In the latter camp, while the prospects for Warren seems to be fading in favour of Sanders, there are some fundamental issues at stake (dismantling of big techs, energy policy, health care, regulation, foreign policy). Therefore, we could expect a rebalancing among other sectors/stocks. Investors **who seem convinced that Trump will easily win the elections may have to reconsider their position** and this could be a source of volatility. **Third area of surprise could be in EMs**, with possible regional divergences. China (and dependent countries) could benefit from a relief in trade war. The CEMEA region could benefit from its dependence on European demand, while Latin America could be vulnerable to political turmoil and investor flows.

All in all, **2020 will be a year dominated by politics and surprises** – Europe moving towards fiscal constraint relaxation, US election campaigns and idiosyncratic stories of political instability in EMs. Instead of trying to predict the unpredictable, investors should focus on building resilient portfolio on five principles:

- **Capture the cyclical rebound** in the first part of the year, being cautious on duration with a possible bottoming out of bond yields, and favouring cyclical value stocks, especially in Europe.
- **Exploiting opportunities in EMs**, given that a possible depreciation in US$ next year would support investing in EMs, particularly in the local currency debt.
- **Monitor the triggers for alternative scenarios, and hedge against extreme events**. A restart or worsening of trade war would trigger a recession, ending the bull market in equities and putting pressure on credit market. In the upside scenario, a massive fiscal stimulus in favour of green economy and social equalities could put markets on a sustainable path, but pressure bond yields.
- As these outcomes drive very different market implications, investors should **maintain adequate liquidity** buffers in case any of these diverging scenarios come to fruition.
- Finally, **ESG investing will become even more relevant to targeting both risk-adjusted performances** and impact on economic and social models negatively affected by long-term risks, such as **inequalities and climate change**.

[1] *50% MSCI World in EUR 50% Global Aggregate Bond Hedge EUR.*

Overall risk sentiment

Risk off — Risk on

We are overall neutral on risk, but remain prepared to benefit from any upside.

Changes vs previous month

Reduced US duration to a more neutral stance

Overall risk sentiment is a qualitative view of the overall risk assessment of the most recent global investment committee.

MACRO

Risk of hard Brexit falls, but uncertainty remains

DIDIER BOROWSKI, Head of Global Views
MONICA DEFEND, Global Head of Research

Orderly Brexit to happen in January 2020. After the broad Conservative victory at the 12 Dec. election, an official Brexit by the end of January 2020 looks very much like a done deal. The UK will then enter a transition period during which it will: (i) temporarily retain its access to the EU's Single Market, (ii) attempt to negotiate a new, permanent trade framework with the EU. This transition period will last until Dec. 2020, although it could be extended until as late as Dec. 2022 i**f the EU and UK agree to this extension before July 1 2020.**

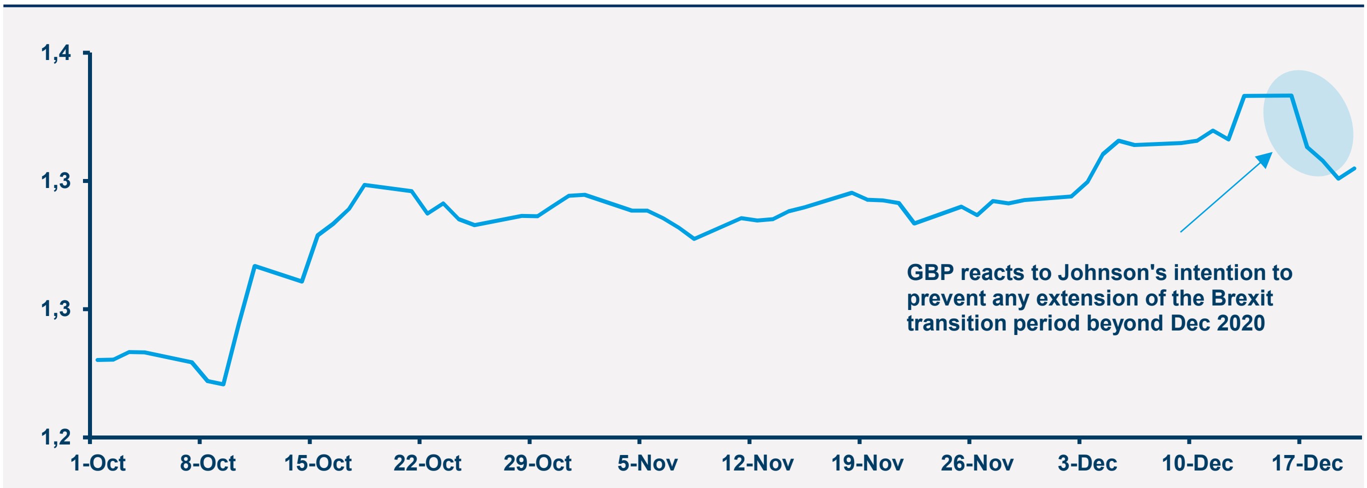
Increased perception of another "No-deal" risk in Dec. 2020. The confirmation by the new UK government that it will not seek an extension of the transition period beyond Dec. 2020 has increased the perception that there could be another "hard Brexit" trade shock if the UK and EU are unable to negotiate a trade agreement before then. This threat is not entirely new as the intention not to extend the transition period was clearly stated in the Conservative Party's election manifesto. In addition, some observers have already commented that an 11 month delay seemed far from sufficient to negotiate a comprehensive trade deal. **Nonetheless, the very strong tone of the UK government (notably its announcement that an extension of the transition period could be prohibited by law) came as a surprise.** The government also stressed that it wants to restore the country's regulatory autonomy vs. the EU. This position is more compatible with a 'simple' free trade agreement than with a closely-knit trade relationship.

> "The government's confirmation that it will not seek an extension of the transition period could be a way to open the deal negotiation on a hard stance which can be softened later."

We believe that negotiations will be tense, but do not expect a no-deal crash out of the transition period in December 2020 (with UK-EU trade governance falling back to a raw WTO regime). Clearly, after his significant electoral victory, the UK PM's quick and explicit leaning towards the hard-Brexit wing of his party was unexpected.

However, we see this move as post-electoral posturing and a way to open the deal negotiations with a hard stance that can potentially be softened later. Even if the prohibition of an extension of the transition period is legislated, **we believe it is pragmatism that will prevail in the end.**

GBP/USD spot price



Source: Amundi on Bloomberg Data, as of 22 December 2019

Alternative scenarios to a no-deal in December 2020 will remain open, in our view. For instance, the completion of a free trade deal by December 2020 (possibly a temporary one) at least for goods, despite the very short delay, could be envisaged even though there is no historic precedents (the shortest trade deal negotiation for the EU was apparently that with South Korea, which took 2.5 years). This is because the UK and EU start from a position of closely aligned internal market regulation. **Moreover, should an extension be outlawed, the British government could still backtrack** and change its law again to allow for an extension of the transition period. However, it is very much possible that stress related to the new "no-deal" risk could rise further in the coming months before receding eventually.

At the end of the day, we continue to view UK equities as attractive (especially domestically oriented and cyclicals) since the worst had already been partially priced in by foreign investors, who have remained massively underweight over the past three years. **Having said that, the sterling is likely to experience unpredictable highs and lows, depending on the course of negotiations.**

MULTI-ASSET

Easing political risk tactically supports risk assets

MATTEO GERMANO, Head of Multi-Asset

After the moderate global slowdown experienced in 2019, growth conditions worldwide are expected to stabilize in 2020. While the quality and composition of growth (still weak Capex growth in US) will likely lead to further economic vulnerability, we do not expect to see a recession in next 12 months. In DMs, fiscal push will be limited and un-coordinated, but EMs are showing relative resilience with a moderate reacceleration expected in 2020. The global inflation outlook remains benign and temporary upside risks should be contained and linked to tariffs. However, possible alternative scenarios may play out, as there are many areas of uncertainty, especially on the political front. This highlights **the importance of a flexible approach for 2020,** similar to that which characterised 2019, when we adjusted our stance during the year. We started 2019 with a defensive approach, with an aim to limit downside risk and protect investors' portfolios. **But, we are ending the year with an improved tactical view of risky assets**.

High conviction ideas

Our strategic assessment of equities has not changed and accordingly, we remain defensive. However, tactically speaking, a phase one trade deal and a potentially favourable evolution of policy mix could give a boost to the market. As a result, we are now less negative on European and US equities, although overall we maintain our cautious stance in both regions. In the UK, with Tories winning a majority in the parliament, political stability and less uncertainties surrounding Brexit should benefit the domestic market, leading us to be more positive on FTSE250. This should also support GBP/USD which will benefit UK large caps.

> "We see less scope to take directional views on duration, and we continue to believe that credit is the place to be in risk assets in this phase of the cycle."

In fixed income, **we have now a neutral view on US duration,** as yields are expected to remain range-bound in the next couple of quarters. Therefore, we focus on a more tactical approach here, as a market correction could be an opportunity to add duration. The **current late cycle environment is favourable for credit.** We remain positive on IG (but prefer EUR over US due to lower leverage) in light of healthy fundamentals and technical factors. In HY, we are more positive on EUR vs US. Due to the aggressive **hunt for yield** in Europe, we remain optimistic on Italy 30y vs Germany 30y as the Italian curve is one of those exceptions where attractive yield is still available. Nevertheless, we stay vigilant regarding the recent resurgence of political risk (regional elections in Italy in January will be a key test for the Government coalition).

Within EMs, the environment is benign for EM debt (HC) due to attractive carry, high relative yields, subdued inflation and dovish EM Central Banks, but hedging the duration and currency risks is important. We have a neutral view overall on equities, but we prefer domestic consumption stories and we believe investors should play EM relative value opportunities (China vs EM and Korea vs EM). We remain cautious on FX exposure.

In **DM FX**, we are now more constructive on EUR vs USD amid expectations of asymmetric payoffs in favour of EUR gains. USD will have less support from growth and interest rates differentials as they are expected to diminish over 2020. EUR/USD looks undervalued vs medium term fundamentals (productivity, trade openness). Technical factors and sentiment are also positive for EUR (market positioning is short but interest in EUR is rising).

Risks and hedging

Trade negotiations between the US and China will go beyond short term relief and could intensify again. Another area of uncertainty is related to CB policies. As a result, we suggest investors have **adequate hedges** in place that could limited the downside in case of unexpected events.

USD = US Dollar, IG = Investment grade, HY = High yield

Amundi Cross Asset Convictions

	1 month change	---	--	-	0	+	++	+++
Equities					■			
Credit							■	
Duration	↘				■			
Oil					■			
Gold						■		
Euro cash				□				
USD cash						■		

Source: Amundi Research. The table represents cross asset assessment on a 3-6 month horizon, based on views expressed at the most recent global investment committee. The outlook, changes in outlook and opinions on the asset class assessment reflect the expected direction (+/-) and the strength of the conviction (+/++/+++). This assessment is subject to change.

FIXED INCOME

Opportunities in the broad credit universe

ERIC BRARD, Head of Fixed Income
YERLAN SYZDYKOV, Global Head of Emerging Markets
KENNETH J. TAUBES, CIO of US Investment Management

The performance recorded in 2019 will likely be difficult to repeat but the landscape for global fixed income investors remains broadly positive with main Central Banks set to pause the rate cut cycle, but are expanding their balance sheets again. As a result, **supportive technicals and persisting search for yield continues to drive credit markets**. Here, we look at a broad range of opportunities, beyond the traditional IG space. Duration is not the name of the game at the moment: core bond yields have probably bottomed out in this phase but the direction is not set yet and we expect a broad trading range in core bond yields. Overall, we are carefully monitoring liquidity, which could be low as we close-in on year-end.

DM bonds

On a global fixed income perspective, while we have an overall neutral view on duration, we keep a positive view on US vs EUR and Japan. We remain constructive on peripheral bonds and we recently re-assessed the potential for Italy (more positive) and Spain (less constructive) to reflect the changing situation in the two countries. Investors could also play yield curve opportunities, such as curve steepening in the UK and Canada and flattening in Australia. In credit, we remain broadly constructive, especially in Europe in both IG and HY. Within the former, **we find interesting opportunities in subordinated financial.**

In US, the Fed has signalled a high bar for future policy actions and will likely keep rates 'on hold', unless inflation persistently exceeds its 2% target (unlikely) or growth outlook materially deteriorates (not our base case). As the drag from the trade war recedes, we expect near-term US growth to stabilize around potential at close to 2%, provided global trade environment does not deteriorate. A macro-economic **environment marked by stabilizing growth and a patient but supportive Fed should be positive for risk assets**. In particular, structured securities, including both agency and non-agency Residential Mortgage Backed Securities (RMBS), are attractive relative to IG. This is because fundamentals within the housing market remain positive, with low mortgage rates boosting new home sales, prices and affordability. **For corporate bonds**, although we are positive in light of stabilizing growth and a supportive Fed, we are watchful of leverage in IG. HY is attractive on a selective basis, given the technical conditions in the low quality bank-loan segment.

> "The Fed and the ECB are set to pause the rate cut cycle, supporting the case for bottoming out of core yields."

EM bonds

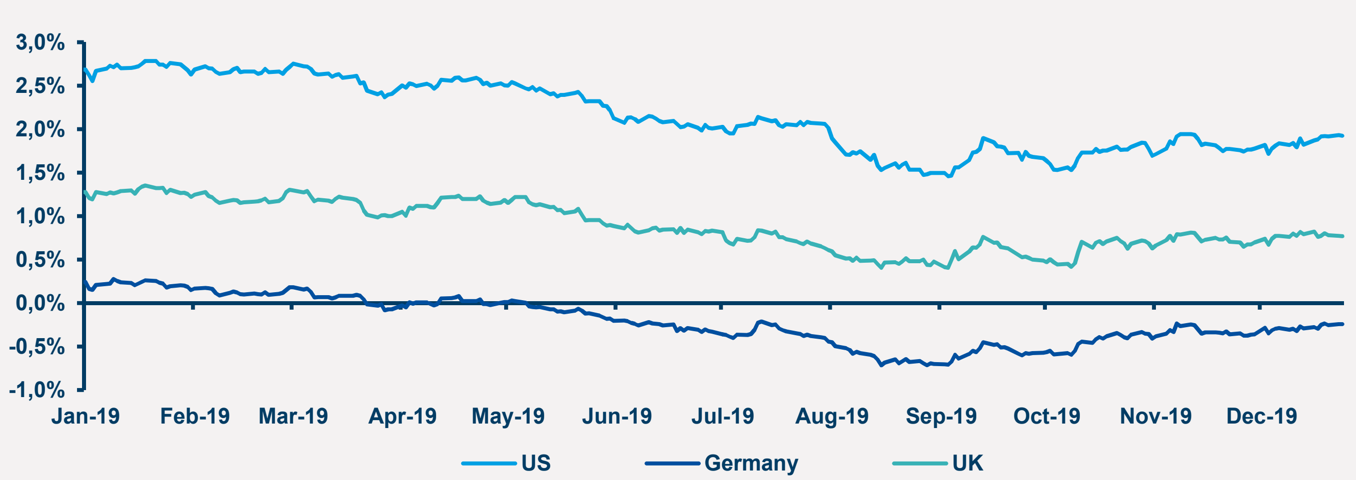
We are constructive on EM fixed income and believe this asset class will continue to offer value in the year ahead. From a top-down perspective, within external debt (sovereign and corporate) we favour Brazil, Bahrain, Indonesia, Serbia and South Africa, but we are very selective in Sub-Saharan Africa. Regarding EM rates, we are positive on Egypt, Indonesia, Russia, Serbia and Ukraine. In FX, while we turned less bearish, we are still cautious overall. Asian high-yielders (India, Indonesia and Philippines) appear attractive, but we are cautious on growth/trade-sensitive countries such as Korea, Taiwan and Singapore.

FX

On GBP, election uncertainties are over but the rally has been strong and there has been scope to take some profits. There will still be support for GBP near term as investors have to react to the new situation but soon the market will focus on the difficult negotiations at the end of 2020

EM FX = Emerging markets foreign exchange, YTD = Year-to-date, IG = Investment grade, HY = High yield, GBP = British Pound, RMBS = Residential Mortgage backed Securities.

10Y government yields



Source: Amundi on Bloomberg Data, as of 17 December 2019

EQUITY

PMI bottoming out to favour value and cyclicals

KASPER ELMGREEN, Head of Equities
YERLAN SYZDYKOV, Global Head of Emerging Markets
KENNETH J. TAUBES, CIO of US Investment management

Overall assessment

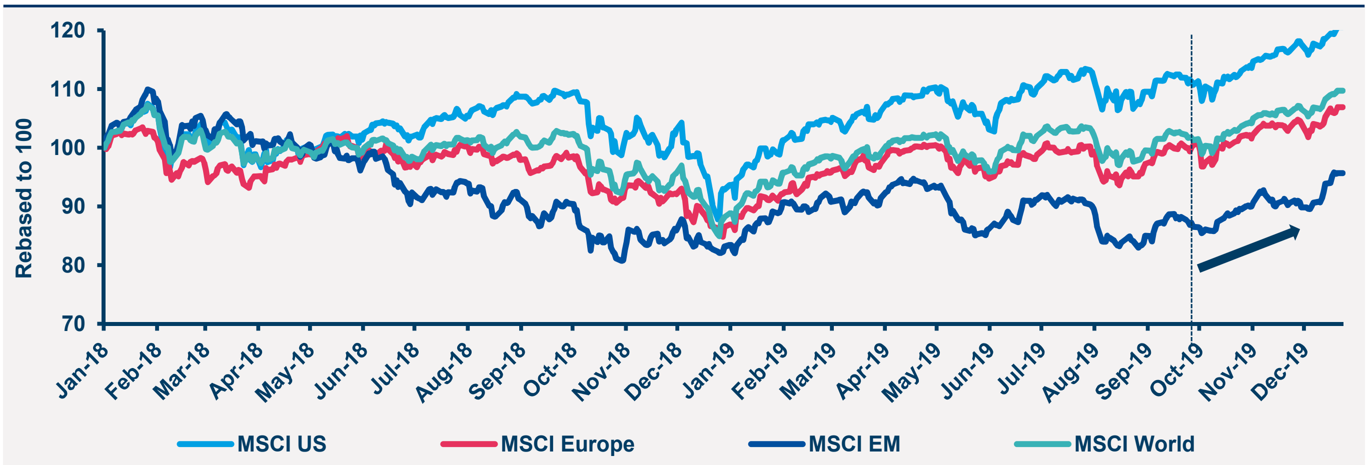
Equity markets appear to be closing the year on a strong note, with the S&P500 setting new highs and European Stoxx 600 above the previous 2015 highs. Japanese equity has also rebounded on the back of attractive valuations. Looking ahead, while 2020 consensus earnings expectations may still be somewhat too optimistic, support for earnings growth in H1 2020 seems strong in the US. Even in Europe earnings revisions are stabilising. In our view, the macro outlook of low growth with no recession, **PMI** (purchasing manager index) **bottoming out and dovish Central Banks should continue to support some further extension of the uptrend.** Risks continue to persist mainly related to the trade war, although political risks in Europe have receded after UK election. As a result, we believe that from a global perspective the most attractive areas are in non-US equities (mainly Europe) and in US value.

> "Since Q4 2019, a PMI rebound is occurring at a time of extreme overvaluation of global growth vs value, thereby increasing the chances of this rotation."

DM equities

The recent signs of bottoming out of manufacturing in Europe, low unemployment rates and resilient demand **support the case for relative attractiveness of European equities (also based on valuations)**. In addition, UK elections result has reduced the short-term Brexit risk and favoured a return of investor appetite to the region. Since the start of Q4, there has been some **rotation towards value that we believe could continue in 2020**, given the extreme dislocation in value vs growth valuations. Support to the continuation of this trend will come, in our view, from PMIs bottoming out. When playing the European markets, investors should favour the more cyclicals components, but maintain a selective approach. At a sector level, we prefer energy and industrials among cyclicals and health care amongst the defensives. European small and mid-cap stocks could also benefit from the improvements in the manufacturing outlook and a potential Brexit deal.

Global stocks in reacceleration mode



Source: Amundi on Bloomberg Data, as of 18 December 2019. MSCI World = MSCI ACWI

In the US, we believe that earnings growth is needed to support further upside in the broader market. Stronger top-line growth, manageable wage inflation and a potential pick-up in economic activity suggest that the trajectory of profit margins is likely to reverse positively.

For H1 2020, we see potential for equities to deliver attractive returns, but this is contingent on continued progress on the US-China trade front and Brexit. In such an environment, **value and cyclical stocks remain attractive**. Here, we maintain a focus on quality, seeking areas of resilience in case of a trade war escalation. At a sector level, we have become more constructive on health care (diminishing prospects of Warren election) and continue to favour mega cap financials in the high quality cyclical space. We remain cautious on bond proxies such as consumer staples and utilities owing to their high valuations and on industrials and information technology. Overall, dispersion in stock prices favours an active approach.

EM equities

We maintain our constructive view on EM equity but are very selective. A widening of the growth premium vs DM in favour of EM is likely and this will modestly support EM equities. In addition, EM equity valuations appear relatively attractive (MSCI EM trades at 32% discount relative to S&P500) and we believe ongoing stimulus measures would support the economy. As a result, we focus on ‘self-helping’ countries (domestic consumption) such as Russia and Indonesia.

Amundi asset class views

Platform	Asset Class	View	1M change	Rationale
EQUITY PLATFORM	**US**	=		US valuations appear reasonable but earnings must grow to further support the uptrend. We have a focus on value and cyclical compartments. Active stock picking is crucial, amid high dispersion of returns.
EQUITY PLATFORM	**Europe**	=/+		PMIs bottoming out, lower Brexit tail risks and UK political stability support a return of flows to European equities. Extreme market dislocations in Value vs Growth could also favour value markets and Europe in particular. In our view, cyclical segments offer compelling opportunities.
EQUITY PLATFORM	**Japan**	=		Japanese equities rebounded but their valuations still remain attractive. This is a cyclical market that could benefit from a cyclical rebound. Corporate balance sheets are underleveraged and buybacks are increasing. However, this market remains more exposed to Yen dynamics and sensitive to US China trade dispute evolution. So we prefer to keep a neutral stance.
EQUITY PLATFORM	**Emerging markets**	=		EM equities are attractive on a relative value basis and we believe low interest rates and some fiscal easing would support growth. We favour domestic consumption stories. However, we are very selective in light of concerns on earnings slowdown and political instability (idiosyncratic issues in Latin America, Turkey).
FIXED INCOME PLATFORM	**US govies**	=	▼	We have a neutral duration view, given our conviction that the Fed is under no pressure to veer from its "on hold" stance with few signs of igniting inflation expectations. Broad trading range in bond yields expected in 2020
FIXED INCOME PLATFORM	**US IG Corporate**	=/+		We are positive owing to stabilising growth and a supportive Fed but are mindful of high leverage of US corporations that is affordable when interest rates are low. We watch for stress in the event of higher rates and given that spreads are grinding towards multi-year tights. A strong focus on corporate fundamentals is essential at this stage of the credit cycle.
FIXED INCOME PLATFORM	**US HY Corporate**	=		HY spreads are getting tighter and we are mindful of the leverage levels in this segment. Attractive opportunities are available on a selective basis
FIXED INCOME PLATFORM	**European govies**	-/=		We are cautious overall on duration given that the ECB is set to pause the rate cut cycle and there is increasingly nervousness on negative rates. This could drive a bottoming out of bond yields. However, we remain positive on peripheral bonds, (especially Italy) as QE program restarted.
FIXED INCOME PLATFORM	**Euro IG Corporate**	++		We are positive on EUR IG which should benefit from the QE program and the 'Subordinated Debt Financial' space looks attractive. This asset class remains crucial for investors as EUR IG would continue to add value to European Fixed income portfolio in 2020.
FIXED INCOME PLATFORM	**Euro HY Corporate**	+		Technical factors are supportive of the asset class but we are selective, particularly in industrials sectors such as energy, and automobiles. Activity is trending lower in HY ahead of the year-end but is expected to return back to normal in January with supportive conditions provided by an active primary market.

Amundi asset class views

	Asset Class	View	1M change	Rationale
FIXED INCOME P.	**EM Bonds HC**	+		We are constructive on EM HC bonds where we still see value given that the carry component is still significant. EM growth is expected to accelerate modestly, but we should be aware of some idiosyncratic stories due to political risk in some areas.
	EM Bonds LC	=		Real yields in local currencies bonds will remain attractive as we expect more easing from EM CBs, given that inflation is under control. We favour high yield countries as they have more space to cut rates. Meanwhile, we do not expect EM currencies to appreciate going forward and thus we remain cautious. However, we prefer Asian FX over other regions.
OTHER	**Commodities**			Commodities remain relatively cheap, due to easing financial conditions and decent economic growth. Central banks' active management of balance sheets is another factor that will play an important role in likely supporting prices of precious metals such as gold. Therefore, we remain constructive on the metal for 2020. For oil, US production and OPEC strategy will be the key price drivers for 2020. OPEC would likely remain vigilant and very active on output cuts mitigating external shocks. We maintain our target range of $55-$65/bbl for WTI and $60-$70 for Brent, but we acknowledge the downside risks arising from cooling global oil demand and sluggish Chinese growth. We are constructive on base metals as we think the manufacturing sector could stabilize in light of a slight rebound in world trade and somewhat better economic data.
	Currencies			We expect the EUR/USD to trend slightly lower, on a 12M basis to 1.13, due to diminishing rates advantage between the US and Europe. EUR/USD appreciation is likely but is dependent on economic growth in Europe. The GBP/USD already touched our 12M target of 1.31, but there are concerns as Johnson aims to pass a law, prohibiting the UK from seeking an extension of the transition period (with or without a deal). For USD/JPY, our 12M target remains unchanged at 104. EM FX appear fairly valued and we don't see upside at aggregate level for the next 12 months, with USD/CNY trading in the range for 7.10-7.20 in 2020.

LEGEND

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	Negative		Neutral	Positive			Downgrade vs previous month	Upgraded vs previous month

Source: Amundi, as of 18 December 2019, views relative to a EUR-based investor. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research, investment advice or a recommendation regarding any fund or any security in particular. This information is strictly for illustrative and educational purposes and is subject to change. This information does not represent the actual current, past or future asset allocation or portfolio of any Amundi product.

IG = Investment grade corporate bonds, HY = High Yield Corporate; EM Bonds HC / LC = EM bonds hard currency / local currency. WTI= West Texas Intermediate. QE=quantitative easing.

THIS MONTH'S TOPIC

Europe at an economic policy crossroads

DIDIER BOROWSKI, Head of Global Views

Finalised on 07/01/2020

The essential

The new European leadership (at the head of the European Commission and the ECB), combined with **historically low real interest rates**, provides a unique **opportunity to rethink** priorities in order to meet the challenges at hand (economic, financial, environmental and security challenges). **In economic terms, strengthening Europe and improving its competitiveness means tackling all these challenges simultaneously.**

At the level of economic policy, the link between monetary and fiscal policy must inevitably be rethought. But that's not enough. The expansionary policy mix must be accompanied by an improvement in the financial architecture.

We identify two pillars on which the European authorities should be able to act significantly in 2020-21: the Capital Market Union and budgetary rules. This is a prerequisite for dealing with the inevitable macro-financial shocks that the future holds. Against this backdrop, the voices of Christine Lagarde and Ursula von Der Leyen (Presidents of the ECB and the Commission respectively) are eagerly awaited.

On an international scale, Europe is struggling to establish itself, in particular against the two giants, the United States and China. The European Union (EU) must therefore be strengthened at all levels: political/diplomatic, security/defence, financial architecture, development of high technologies, financing of the energy transition, etc.

The new European leadership (at the head of the European Commission and the ECB), combined with **historically low real interest rates**, provides a unique **opportunity to rethink** priorities in order to meet the challenges at hand:

- **An economic challenge:** the combination of low potential growth and high public and private debt is clouding the medium- and long-term outlook. Of course, this is not just a European issue. But structural reforms are still needed. In addition, one of the priorities will be to channel the (very abundant) savings to investment projects with a promising future.
- **A financial challenge:** the Europe of capital is still too fragmented; on the one hand, Europe relies too much on its banking system and, on the other hand, cross-border investment in the region is clearly insufficient (savings circulate poorly between north and south), which limits the resilience of the Eurozone (EZ) in the event of an asymmetric shock. Moreover, banks are still too exposed to their own sovereign securities held on their balance sheet (the "*doom loop*").
- **An environmental challenge:** the "social demand" in this area is very high, as shown by the breakthrough of the Greens in the last European elections. There is a sense of urgency that needs to be addressed. The Commission is ready to commit itself. The ECB says it is ready to help. All levers must be mobilised to meet this challenge (investment, taxation, regulation).
- **A security challenge:** there are many areas of tension. There is nothing new except that this situation will continue, *especially* if Donald Trump is re-elected as president in November 2020. Europe will have to acquire a credible defence structure – which will require increased investment in technology and security – and uncertainty will rise due to the tensions between the two blocs.

In economic terms, strengthening Europe and improving its competitiveness mean tackling all of these challenges at the same time. As Kennedy already noticed nearly 60 years ago, it is indeed when the weather is nice that the roof has to be repaired[1]. But the clouds are gathering. Uncertainty about Europe's future is weighing on confidence. Restoring confidence is a sine qua non for investment. The "European house" will be able to cope

[1] *"The time to repair the roof is when the sun is shining"* (J-F. Kennedy, State of the Union Address, 11 January 1962).

with a little rain (i.e. a moderate recession), but its financial architecture is still too weak (excessive economic, financial and regulatory fragmentation, uncoordinated fiscal policies, monetary policy that is reaching its limits) to weather a storm (big recession and/or severe financial crisis). Not to mention that it is still powerless in military terms (especially in comparison with the United States and China), but this is another debate.

At the level of economic policy, the link between monetary and fiscal policy must inevitably be rethought. But that's not enough.

The burden of macroeconomic stabilisation cannot rest with the central bank alone. Negative interest rates and the ECB's QE are ultimately weakening the macrofinancial system, while the economic impact is increasingly questionable.

Fiscal policy can help stimulate investment because the debt constraint is naturally eased by lower interest rates, which increases the room for manoeuvre. **But public debt is already too high in many countries**. It is therefore right to focus attention on those states in the EZ that have the means to act (primarily Germany). **However, fiscal policy is not the alpha and omega of Europe's stabilisation capacity.** And it is certainly not through fiscal policy alone that the authorities will be able to improve European competitiveness.

It is not just a question of increasing external competitiveness. The main aim is to improve investment attractiveness. **The EZ is penalised by its financial architecture, which is too fragile in the eyes of many foreign investors.** The result is a form of political risk premium on European assets (which are more affected by mistrust as soon as global conditions deteriorate).

The expansionary policy mix must be accompanied by an improvement in the financial architecture. The need for a federal budget is often mentioned, and this goes hand-in-hand with the need to create a European *safe haven*. This progress is essential for the long-term stability of a monetary union. Having said that, we must be realistic, the European states are not yet ready to take this step; it can only be the culmination of a process of further financial integration.

The EZ benefits from an excess of savings and a shortfall of investment. Improving the circulation of savings within the zone is a priority. **Households' asset allocation no longer corresponds to the new financial situation**. Their savings are over-invested in debt securities. To remedy this, savers' financial education should be improved and they should be encouraged to diversify their savings into risky assets, including European cross-border investments.

The EZ is still too dependent on its banking system: access to the capital market for SMEs must be facilitated. All the more so as the banks, for their part, are weakened by low interest rates and by their ownership of their own sovereign debt.

In the meantime, all reforms aimed at improving the EZ resilience will improve its attractiveness and competitiveness. Europe's needs and challenges are clearly identified. There is an awareness among the authorities of the need to act, but there is still a lack of agreement on the means to be implemented, particularly between Northern and Southern Europe. Close consultation is needed to find a compromise. Europe must also find voices that embody Europe and its place on the international stage. The voices of Christine Lagarde and Ursula von Der Leyen (Presidents of the ECB and the Commission respectively) are eagerly awaited.

We identify two pillars on which the European authorities should be able to act significantly in 2020-21: the Capital Markets Union and budgetary rules.

Capital markets union (CMU) is a prerequisite

Empirical work shows that *risk* sharing - much more than fiscal and budgetary integration - is what allows the US economy to absorb shocks, especially when they are asymmetric. In particular, we note that the resilience of the US economy stems from the fact that companies rely more on market financing, which makes the US economy less sensitive to a banking shock.

- A more integrated financial system increases the system's resilience to shocks. **The more geographically distributed the risks, the greater the stability of the Union.** The idea is quite simple:
  - If a country enters a recession, but households and businesses in that country receive dividends and interest income from other countries that are not in recession, that income will help stabilise the country in recession.
  - The same applies when a country's banking sector is affected by a crisis and has to limit the distribution of credit to the private sector. Access to finance will be much easier if households and businesses have access to banks and investors in non-crisis countries.
- Risk sharing is not currently provided through the capital markets. It can be achieved by encouraging cross-holding of assets from other countries in the EZ.
- Tax rules are still too complex for cross-border transactions and national insolvency procedures are too different.

The benefits of the CMU are still very poorly understood by the general public and there is therefore little public support for action in this area. But that should not stop the authorities from taking action.

Rethinking budgetary rules

This is a very sensitive issue for the new European Commission. In fact, the European states have never observed the rules of the Stability and Growth Pact. The core EZ countries were even the first to set a bad example. More than twenty years after the launch of the euro, there is now a near consensus on the need for new and more credible rules, for the following reasons:

1. The rules have become too complex, which has undermined their effectiveness;
2. The framework has become more opaque over time: many indicators at the heart of the approach are not directly observable (output gap, structural budget balance) and are thus the subject of endless debate among economists.
3. The division of roles between the Commission (initially responsible for legal and economic analysis) and the Council (political body) has become less clear-cut over time. The Commission now plays a key role in imposing penalties, which is probably not desirable.
4. The penalties have not worked. A budgetary framework without any correction mechanism is not credible.

The current framework is the result of a stack of reforms that have made the rules more complex over the years. It is striking that the rules have become more pro-cyclical. The first elements of flexibility and cyclical corrections were introduced before the Great Financial Crisis, when the Eurozone economy was in good health, but the framework was strengthened during the crisis. New elements of flexibility have been added since the sovereign debt crisis, leading to an easing of fiscal targets. This results from the underlying pro-cyclicality of fiscal policies in the EZ and underlines the difficulty of applying a supranational fiscal framework. The Stability and Growth Pact is the result of a political compromise between the Member States. **In the new macrofinancial context, it will be up to the Commission to work on a new compromise that improves the governance of the monetary union without calling into question the existence of rules.** Democratic adherence to these rules will come from their stabilising nature in the event of a crisis.

Conclusion

All in all, Europe, and more particularly the Eurozone, seems to us to be ready to face a "small" recession, through a combination of accommodative monetary and fiscal policies. However, in order to avoid lasting fiscal slippage, it is essential to anchor the credibility of fiscal actions with clear counter-cyclical rules. This means that in periods of expansion, spending will have to be more constrained. **On the other hand, to counter a "great crisis" or a very severe recession, the financial architecture of the Eurozone is still insufficiently consolidated.** This is the task that the European authorities must now tackle; not so much because a crisis is looming, but because a region's resilience is the foundation of confidence.

Top Risks Map

Macroeconomic Research Team

The table below presents risk factors with judgmental probabilities (i.e. not market based). It also develops the possible market impacts.

Finalised on January 10, 2020	Analysis	Market impact
20% Trade war escalation	The announcement of the Phase one deal signature ad some of the anticipated details are in line with our base case though provide an outlook slightly more constructive (partial rollback of tariffs). Yet, the most complex issues (intellectual property rights, technology transfers, tariffs already in place and the Huawei case) have not been addressed yet. Keep in mind that the US is entering a pre-election period, and opposition to China goes far beyond the Republicans. Whoever the US President is next year, opposition between the two countries on strategic issues could worsen their relations in the coming years. The likelihood of a global trade agreement is very low. Twists and turns continue to deteriorate business confidence, manufacturing has yet to bottom out and profit deterioration continues.	• Negative for equity and CNY • Positive for USD, US Treasury and gold
20% Mounting corporate vulnerabilities	Corporates have been piling up debt to levels even higher than pre-GFC. Sobering earnings dent corporates' ability to service that debt and cover interest rates payments. At the same time, EM and frontier markets have been attracting capital flows from advanced economies, increasing their external debt. Tightening financial conditions and higher rates will hurt their ability to pay down their debt. Widespread distress and default rate spikes will force deleveraging and a pullback on investment and employment, exacerbating the recession.	• Negative for risky assets • US IG BBB downgrade, EURO and US HY B-CCC default increase • Positive for USD, US Treasury and gold
10% China hard landing	Chinese economic growth is slowing down, but authorities are working hard to stimulate the economy (through monetary and fiscal policies), so that it will remain on a manageable slowdown path. Recent data indicate that the trade war is biting and a supportive policy mix is necessary. China's economic model is fragile, with signs of excessive credit. Non-financial corporate debt has surged since the GFC.	• Global financial instability • Negative for oil, basic materials, currencies of commodity-exporting countries, EM bonds • Positive for US Treasury /Bund and gold
10% US elections	At this stage, there is not trivial result on US presidential election outcome. While investors community focuses on the polls , it is critical to have a look at the policy actions that will follow from the president elected (welfare and financial regulation, in particular). The risk scenario escalates from impeachment proceedings, more extreme foreign policy measures that might led the situation to implode on Ukraine, Iran and Syria, the possibility of tax rates applied to corporate earnings under a new administration therefore faltering confidence and sinking economy.	• Volatility increase • US markets disruption • Positive gold
10% Escalating military tensions with global spillover	China/US, China/HK, Brexit, Iran/ ME, Lybia Geopolitical dimension has a prominent influence on markets. January strikes in Iraq raised concerns about military escalation with implication on oil price and global dynamics. Markets continue to price in a major escalation is unlikely, with minimal corrections on safe haven (gold, treasury, oil, USD, YEN) and risky assets (DM equities) after gain/losses. We expect no further escalation from US or Iraq; we expect oil price spikes to stay short lived (unless oil supply disruption from Iraq takes place).	• Positive for oil prices and safe haven assets (FX and gold) • Negative for risk assets
10% Credit illiquidity & risk misallocation	The search for yield has pulled institutional investors in a low rate environment towards credit risk accumulation in their portfolios. Liquidity buffers have been decreasing to achieve nominal targets. The critical juncture of a maturing credit cycle and a shift in markets' structures amid regulatory changes, in case of a sharp sell-off, might prove a tangible obstacle to investors selling their positions.	•Positive for cash, govies (US, Euro) and gold • Negative for EM bonds, global equity, HY, oil and basic materials
10% Drying USD liquidity	US dollar funding liquidity and a shrinking USD liquidity base could amplify the impact of a tightening in funding conditions and create spillover to countries that receive cross-border USD loans.	• Global financial instability • Positive for gold and US Treasury • Negative for risk assets (EM in particular)

MACROECONOMIC CONTEXT

Our convictions and our scenarios

Macroeconomic Research Team

This section provides a reminder of our central scenario and alternative scenarios.

CENTRAL SCENARIO (55% PROBABILITY): Resilient domestic demand and services despite uncertainty still affecting trade

- **Slower global growth:** the economic weakness seen worldwide during the summer continued into the fall with very few exceptions. Industrial surveys and data continue to show that the global manufacturing sector is not out of the woods yet, although the Phase One deal between US and China may provide some relief. Domestic demand remains more resilient, due primarily to household consumption, which continues to be buoyed by very low inflation and, in certain economies, by strong labour markets. Still, services have proved more resilient than manufacturing.
- **Global trade expected to bottom out in H1 2020:** global trade has plummeted over the past 18 months, driven down by protectionist rhetoric. The damage so far to world trade momentum and the real economy will not be easily and quickly reversed, although the US and China have reached the much-awaited Phase-One deal. We expect global trade to recover very slowly in 2020. Indeed, global trade is expected to remain under pressure in the short run and to grow at a slower pace than global GDP next year. The impacts on economies differs from one region to another. European exports are being hit hard by generally weak intra-EU demand and declining ex-EU demand for intermediate and capital goods (in Italy and Germany). The US is advancing steadily on the path of import substitution (imports of industrial supplies and materials decreased from 27% of total imports in 2007 to 18% in 2019). EMs are trying to transform the challenges posed by trade tensions into opportunities. Taiwan is one of the economies in Asia benefitting the most from the trade diversion from China to the US, and it was the only EM economy, among the ones covered, whose performance was upgraded during 2019. In addition, we must not underestimate the resilience of domestic demand at the global level. While global trade has indeed made a strong contribution to global growth over the last few decades, this is less and less so, as global growth is now being driven primarily by domestic demand.
- **United States:** a gradual return to potential, with slightly greater downside risks. The US economy, boosted by very accommodative fiscal policy in 2018, began decelerating in H2 2018 and continued to do so in the following quarters. After peaking at 3.2% YoY in Q2 2018, GDP growth gradually slowed to 2.1% YoY in Q3 2019. Fixed investments have been trending down markedly since the second half of 2019, while personal consumption expenditures have remained resilient overall (3.2% QoQ annualised, revised up from an initial estimate of 2.9%). Protracted weakness in global trade and manufacturing, coupled with uncertainty over the implementation of tariffs, may have played a role in discouraging investments, partially offsetting the benefits of fiscal policy. Corporate and consumer confidence have indeed worsened and only recently stabilised somewhat. Signals are starting to appear that the labour market is decelerating, supporting the view that domestic demand will keep slowing into 2020. Yet we crecognise that over the past the sentiment around "trade war" developments and the signing of a "phase one deal" have turned more positive over the past few weeks. Simmering trade policy uncertainty could support the manufacturing sector and underpin business confidence, hence providing a better outlook for business investments (and, therefore, some upside risk to our outlook). We nonetheless believe that the balance of risks remains tilted towards the downside. Although a truce on the trade front may be reached, geopolitical tensions will persist and political uncertainty may be added to the framework as presidential elections approach. Although we do not expect a recession, doubts on the extension of the current cycle could intensify over the next few quarters (with less support from fiscal policy, and domestic demand decelerating). The Federal Reserve is expected to stick to its dovish bias, signalling reasonable pragmatism and cautiousness in using its "policy ammunition", yet continuing to check financial conditions (mainly driven by the USD's trade weighted strength).

- **Eurozone:** The Eurozone economy remains under pressure, as uncertainty continues to characterize the global economy, although sentiment has improved recently on the US- China trade front. The Eurozone has seen a deterioration in external demand, and the manufacturing sector has been hit severely, raising the question on whether spillovers into services and other important economic sectors were materializing. However, as domestic growth drivers have remained broadly resilient, expectations on economic fundamentals have progressively turned towards a more constructive outlook. Yet, expectations for an improvement in business sentiment, in particular on the manufacturing side, have not fully materialize yet. Flash PMIs for December in Eurozone worsened once again, while the service sector in aggregate seems to remain shielded from this downturn and to still be expanding. We maintain our expectation for the Eurozone economic growth to stabilize heading towards 2020 and 2021 with the manufacturing sector potentially bottoming out, supported also by a more constructive global trade outlook. The labor market is sound in aggregate terms, the unemployment rate remains low, and wage growth is moderate. Household consumption should be the main driver of growth in Eurozone, playing a pivotal role in shaping its way along the growth stabilization process. Signals of expansionary fiscal policies remain limited to country-level implementation but have not taken shape so far as a coordinated effort. A further push remains theoretically possible, in particular should the economy worsen and struggle to rebound.
- **United Kingdom:** the Conservative Party won a large parliamentary majority in the election on 12 December. This allowed the Withdrawal Agreement reached with the EU in October to be ratified in Parliament. Brexit should therefore take place at the end of January 2020. It will be followed by a transition period, during which the UK will retain most of its access to the European single market, which will prevent a trade shock in the short term. During this transition period, the UK and the European Union will have to negotiate a permanent framework for their trade relations (most likely a free-trade agreement). However, at present there is very little visibility as to what will happen at the end of December 2020, when the transition period is set to expire. The transition period could be extended (to the end of 2021 or 2022), but in principle this decision must be made before 1 July 2020 and the United Kingdom has already enacted a law stating it will not seek an extension. Insofar as it seems difficult to negotiate a full trade agreement between now and December 2020, there is a risk that the United Kingdom will lose access to the European market as of this date, in which case trade between the UK and EU would be governed by WTO rules. This would disrupt many business sectors considerably. However, we believe that a solution will be found to avoid this scenario.
- **China:** November's string of data showed a revamp of the weak economic momentum of previous months. We do remain convinced that GDP has remained stable at the range floor of 6% YoY in H2 2019 (Q4 GDP should confirm the level reported in Q3 at 6% YoY) and it will grow below 6% YoY in 2020 (at 5.8% YoY). Chinese authorities have signalled their difficulty of keeping real growth above 6% YoY. Headline inflation has spiked in the recent months, driven by the food (pork prices) component; however, we do expect it moderating following the Chinese New Year celebrations (Q1 2020). The authorities have ramped up their stimulus very mildly to accommodate the still weak economic conditions, in particular on the monetary policy side (with cuts in MLF and LPR in November). Credit growth has very mildly decreased again, driven by RMB loans and local government generic and special bonds. China's surplus with the US is narrowing on the back of marginally higher Imports (as agreed in the Phase One deal) and weaker exports.
- **Inflation:** core inflation remains low in the United States and very low (albeit rising slightly) in the euro zone, despite the strength of the labour market on both sides of the Atlantic. Although the causes of this low inflation are not fully understood, many possible explanations have been put forward. One relates to the poor quality of most of the jobs created in the current cycle (low paid or part time jobs), because workers in these jobs are not in a position of strength to obtain wage increases. Another explanation is the disinflationary nature of structural changes in the goods and services markets (new technologies in trade in particular, and, more generally, the 'uberisation' of the economy). In addition, after years of very low price rises, inflation expectations are low, and this can be a self-fulfilling prophecy. Lastly, recent reforms in the euro zone (labour market and goods and services markets) have created a more competitive environment. Despite these obstacles, we still believe that inflation should rise (until the growth cycle comes to an end), driven by wage rises. However, the increase will be very gradual and the ECB's target ("below, but close to, 2%") seems out of reach for the time being.
- **Oil prices:** Oil prices spiked after Iraq's strikes and in the immediate aftermath of military events/retaliations could move even higher on a temporary basis as the possibility of further actions cannot be ruled out. Yet, unless a full-blown military escalation takes place, with a disruption in Iraq oil production, a sustainable shift to significantly higher oil prices is unlikely, as the elasticity of oil prices to temporary supply shock is lower than in

the past, as other producers can absorb the shock. In particular, US oil production is more flexible than in the past and has proven very resilient, making oil less vulnerable than in the past to supply disruption concerns.

- **Central banks: back to a "wait and see" attitude in AEs.** At the December FOMC meeting, the Fed decided to keep rates on hold after its "mid-cycle adjustment". The so-called "dot plot" of interest rate projections implies interest rates will be left unchanged in 2020. Median forecasts indicate one rate rise in 2021 and 2022. The soft outlook for inflation is keeping a dovish, and not a hawkish, stance for the future. The Fed is keeping its easing bias, despite moving to a more data-dependent approach. In line with market expectations, our central scenario is for another rate cut in 2020, in order to maintain accommodative financial conditions and to keep US growth on track.
  - **ECB:** At her first monetary policy meeting, President Lagarde managed to provide a balanced message. Although acknowledging the recent improved flow of data for the Eurozone, she reiterated the CB's commitment to the current policy stance. Lagarde opened the press conference touching on the ongoing strategic review that the Governing Council is undertaking throughout this year, which will be very comprehensive and the precise scope of which will be given soon. There was very little change in the Eurosystem staff's updated projections, and while risks are still tilted to the downside they have become "less pronounced". QE2 has just started and no major new measures are expected to be delivered in the short term, especially in light of the ongoing strategic review. **Unless a material deterioration in the macro picture occurs, we expect the ECB to keep its rates on hold for the next 12 months, as the bar looks quite high for another cut, given the very limited room left by risks of additional negative effects to the banking system.**
  - **BoJ:** At the December meeting the CB kept its policy unchanged, as widely expected. The forward guidance is unchanged vs last meeting: the BoJ may still consider additional easing in 2020 if geo-political risks increase again and JPY strengthens materially. We expect one, 10bps rate cut in the next 12 months on the following two conditions. First, a cut in the short-term interest rate target must be accompanied by realignment of the three-tiered structure in the BoJ's current account deposit in order to mitigate adverse effects on financial institutions. Second, the BoJ will obviously keep the longer-end of the curve from declining, in order to secure the slope of the curve.
  - **BoE:** At its December meeting the central bank's policymakers voted 7-2 to keep rates on hold at 0.75%. In the minutes they are still indicating that monetary policy could respond in either direction to changes in the economic outlook in order to ensure a sustainable return of inflation to the 2% target. The forward guidance remained unchanged relative to the last meeting. *"Provided these risks do not materialise and the economy recovers broadly in line with the MPC's projections, some modest tightening of policy, at a gradual pace and to a limited extent, may be needed to maintain inflation sustainably at the target"*. **We still believe the likeliest attitude will be to keep rates on hold over the next 12 months.**

DOWNSIDE RISK SCENARIO (30%): full-blown contagion into domestic demand

- Trade war escalates and materialises into a deeper contraction of global trade, a manufacturing slump (with a spillover iknto services) and a currency war. Recession due to globalisation unwinding.
- Exacerbation of idiosyncratic risks (Middle East, Hong Kong, US elections), Chinese hard landing with the policy mix's inability to support a gradual slowdown, with regional and global implication on growth and macro stability.

UPSIDE RISK SCENARIO (15%): modest reacceleration of global growth in 2020

- Fiscal policy support stronger than anticipated both in Europe (Germany and the Netherlands) and possibly the US, too; unexpected coordinated fiscal push at the Eurozone level; this would pose key upside risks of a better policy mix and powerful support to a monetary-policy stance.
- Europe: significant progress on the financial architecture (capital market union, banking union, and flexible fiscal rules) could create a better framework for investments to thrive, stabilise expectations, and improve the monetary-policy transmission mechanism.
- True de-escalation between China and the US, with a meaningful trade agreement.

Macroeconomic picture by area

Macroeconomic Research Team

Finalised on 26/12/2019

United States

US growth gliding along, supported by monetary policy

- Domestic demand keeps slowing, with investment spending hit worse than private consumption. Business climate surveys have worsened over the past few months but have recently shown signs of a tentative bottoming-out.
- Consumer confidence signals are mixed but in aggregate terms still compatible with decent consumption growth in the near future. With softer growth in aggregate income, consumption should moderate going forward, while remaining the main engine of growth. On the investment front, spending plans are slowing.
- Inflation remains low (2.1% headline and 2.3% core inflation); core PCE (1.6% YoY) remains close to, but below, the Federal Reserve's target.
- The Fed flagged that it considers its policy stance appropriate and well calibrated to support moderate growth and resilience on the labour market, and that another cut would require a "material reassessment of the economic outlook". Yet, as we expect some disappointment to come on growth, we are still pencilling another cut for H1 2020.

Risk factors

- Although a trade deal within reach could remove part of the uncertainty, sentiment is not the only factor: past trade actions have materially impacted the economy and will gradually be more visible
- Political uncertainty to rise around the Democratic candidate's program
- Geopolitical risks and tariffs could pose an upside risk to oil prices and to our inflation outlook

Eurozone

Bottoming out

- Q3 GDP growth (+0.2% QoQ) was slightly better than expected, leaving the YoY growth rate at 1.2% and posing the risk of a mild upward revision to our growth outlook for 2019 (currently 1.1%); after a very strong performance of gross fixed capital formation in Q2, investments moderated in the third quarter while household consumption improved above expectations. Going into 2020, we expect personal consumption to remain the key driver of growth, while investments moderate; fiscal incentives to new investments (e.g., "green" investments) may pose upside risks to our forecasts, though.
- December Eurozone flash PMIs were more mixed, highlighting ongoing weakness in manufacturing and resilience/expansion in services.
- Inflation remained subdued and well below the target (November 1% YoY). The new ECB leadership announced the initiation of a strategic review, a long process that should conclude in one year's time.

Risk factors

- The threat hanging over the European automotive sector from US customs duties is a risk that may resurface once the US-China deal is reached
- Domestic political tensions may put at risk the stability of few governments
- Lack of strategic plans/ reforms implementation and design, due to political fragmentation
- Risks of new Brexit "cliffs"

United Kingdom

An orderly Brexit at the end of January 2020

- The Conservative Party's large win in December's elections has set the scene for an orderly Brexit at the end of January 2020.
- However, there is still a big question mark as to whether the UK and the EU can sign a free trade agreement by the end of 2020 (scheduled end of the transition period, which the UK does not want to extend).
- Q3 GDP growth has been revised up to +0.4% from +0.3%. However, several recent statistics (retail sales, PMI) were disappointing.

Risk factors

- Trade shock at the end of 2020 if a free trade agreement with the EU cannot be reached before then

Macroeconomic picture by area

Finalised on 26/12/2019

Japan

A glimmer of hope

- Business conditions of large manufacturers worsened to six-year lows. With eroding corporate profits, companies began to slash payrolls.
- However, there are several green shoots. Despite precarious consumer demand after the sales tax hike and inert exports, manufacturing PMI eventually rebounded in October, thanks to improved semiconductor demand. Companies have accelerated the replacement of the old equipment to boost productivity as well as to cope with the labour shortage.
- The BoJ began increasing monthly outright purchase of short-term JGBs in September. As a consequence, base money growth slightly accelerated and money stock growth followed suit.
- The government announced a sizable economic package, which is expected to boost the economy by 0.7 percentage point over the next two years. .

Risk factors

- **Stagnant global vehicle sales spoil the automotive industry's broad pyramidal structure**
- **Consumer demand collapses on weaker wage growth before the economic measures take effect**

China

- In November, most of the economic data monitored rebounded (except in the Property sector), in line with a form of stabilisation expected ahead. However, economic conditions remain quite sluggish. The trade surplus with the US keeps narrowing as exports continue to decline while imports are mildly increasing.
- Headline Inflation keeps rising, driven by the Food component while Core Inflation and PPI remain muted.
- The policy mix is once again proving only marginally supportive: after reducing the 7-day rate, on 18 December the PBoC reduced the 14-day reverse repo rate by 5bps to inject liquidity into the money market.
- The Phase One Deal has been officially agreed and should be signed in January. The Central Economic Working Conference has set out next year's targets (not yet official): stable growth, no change in the policy mix and enhancing the quality of growth.

Risk factors

- **More details of Phase One deal announced: constructive outcome on tariffs**
- **Some mild improvement in macroeconomic conditions.**
- **The policy mix is still very mildly supportive**

Asia (ex JP & CH)

- Economic conditions in the region remained stable but on the weak side in December. The same signs of stabilization at weak levels came from the first 20 days of exports in South Korea, a sort of leading indicator on the external sector. The base effect mitigated November's negative figures somewhat.
- The region's inflation figures have remained very benign. Noteworthy November figures came once again from India and China, with higher-than-expected food basket components (fuel prices, too, in the case of India), at 5.5% YoY and 4.5% YoY, respectively.
- In December, the Reserve Bank of India unexpectedly remained on hold (at 5.15%) on the back of inflation levels approaching the upper band level.
- Indonesia announced a recalibration of its fiscal deficit target above 3% of GDP. The market reacted nervously to the announcement that has soon turned down by the MoF.

Risk factors

- **Stable weak macro momentum in the region. Phase One deal officially announced.**
- **Inflation still very benign, with a pick-up in China and India.**
- **RBI unexpectedly on hold.**
- **Indonesia announced a revision in the FD target rule.**

Macroeconomic picture by area

Finalised on 26/12/2019

Latam

- Macro momentum in the region has remained stable. Brazilian labour market figures and Colombia economic trends showed some acceleration, while the other main countries struggled further to achieve some improvement in their economic cycle.
- On the inflation front, the overall environment remains benign. Mexican inflation fell marginally below 3% in November, at 2.97% YoY (and the first half of December figure confirms this promising trend, at 2.6% YoY). In Argentina, inflation rebounded again above 50%, broadly supported by all components.
- The easing stance is continuing in Mexico and Brazil (Banxico cutting by 25bps to 7.25% and BCB cutting by 50 bps to 4.5%).
- Following some concessions by President Duque, in Colombia the Congress approved a revision of a tax bill that had been rejected in October by the courts. The President's small political capital and streets protests backed these final concessions.

Risk factors

- **Economic conditions are weak but mildly accelerating in Brazil and Colombia**
- **Inflation is overall benign except in Argentina**
- **Banxico and the BCB cut their policy rates again**
- **A revised financing bill finally passed in Colombia**

EMEA (Europe Middle East & Africa)

Russia: Real GDP growth is expected to slow to 1.2% in 2019. However, it is expected to accelerate in 2020 and over the medium term on the back of a significant infrastructure spending programme from 2019 to 2024 and a lower-interest-rate environment.

- Despite the threat of potential US sanctions down the road, the macroeconomic scenario remains supportive. Russia is one of the few emerging market sovereigns with "twin surpluses" in 2019, while accumulating assets in its National Wealth Fund.
- The CBR cut its policy rate again in December by 25bps, to 6.25%. We expect another 25bp cut in the next twelve months, given decelerating inflation.

South Africa: strong headwinds with a challenging political and social backdrop

- Q3 GDP contracted QoQ, after the rebound in Q2, the latter being mainly thanks to a post-strike recovery in mining. We expect GDP growth of 0.4% YoY or lower by in 2019, with a slight pickup in 2020.
- Despite a negative output gap and declining inflation expectations (but above midpoint), the SARB remains cautious regarding capital outflows and the impact on the exchange rate, hence, upside risks to inflation. Fiscal reforms and risk sentiment will determine whether the SARB cuts rates going forward. We expect the SARB to remain on hold in 2020, unless the February Budget announcement is very encouraging.

Turkey: inflation is on the decline, and GDP growth picked up in Q3- 2019

- The third-quarter growth report showed +0.9% GDP growth YoY, relative to a negative release from the previous two quarters. We expect GDP growth to be flat or slightly negative in 2019, followed by a rebound in 2020, accompanied by a lax fiscal stance.
- The Central Bank of Turkey cut its policy rate again in December, by 200bps to 12%. We expect some more easing to come in support of weak economic conditions.

Risk factors

- **Drop in oil prices, stepped-up US sanctions and further geopolitical tensions**
- **Increased risk aversion, risk of sovereign rating downgrades, rising social demands, and continued fiscal slippage in the absence of reforms**
- **Excessive easing by the central bank, a loose fiscal stance, escalation of geopolitical tensions, and a slowdown in Eurozone activity**

Macro and Market forecasts

Macroeconomic forecasts
(8 January 2020)

Annual averages (%)	Real GDP growth %			Inflation (CPI, yoy, %)		
	2019	2020	2021	2019	2020	2021
US	**2.3**	**1.7**	**1.7**	**1.8**	**2.3**	**2.1**
Japan	**0.9**	**0.9**	**0.8**	**0.7**	**0.8**	**0.6**
Eurozone	**1.1**	**1.1**	**1.3**	**1.3**	**1.3**	**1.4**
Germany	0.6	0.8	1.2	1.5	1.5	1.5
France	1.3	1.3	1.2	1.4	1.4	1.3
Italy	0.2	0.4	0.6	0.6	1.0	1.3
Spain	2.0	1.6	1.6	0.9	1.3	1.4
UK	**1.3**	**1.1**	**1.4**	**1.8**	**2.2**	**2.1**
Brazil	1.1	1.7	1.8	3.7	3.9	4.2
Mexico	-0.2	0.4	1.2	3.6	3.4	3.6
Russia	1.2	1.7	2.5	4.0	3.5	4.0
India	5.1	5.4	5.8	3.6	5.2	4.6
Indonesia	5.0	5.1	5.3	3.0	3.1	3.8
China	6.2	5.8	5.8	3.0	3.7	1.8
Turkey	-1.8	1.5	2.3	15.6	11.6	10.8
Developed countries	**1.7**	**1.4**	**1.5**	**1.5**	**1.8**	**1.7**
Emerging countries	**4.1**	**4.2**	**4.5**	**4.2**	**4.4**	**3.6**
World	**3.1**	**3.1**	**3.3**	**3.1**	**3.4**	**2.8**

Source: Amundi Research

Key interest rate outlook

	13/01/2020	Amundi + 6m.	Consensus Q2 2020	Amundi + 12m.	Consensus Q4 2020
US	1.75	1.50	1.60	1.50	1.55
Eurozone	-0.50	-0.50	-0.50	-0.50	-0.50
Japan	-0.1	-0.2	-0.11	-0.2	-0.06
UK	0.75	0.75	0.81	0.75	0.95

Long rate outlook

2Y. Bond yield

	13/01/2020	Amundi + 6m.	Forward + 6m.	Amundi + 12m.	Forward + 12m.
US	1.57	1.30/1.50	1.60	1.30/1.50	1.63
Germany	-0.586	-0.70/-0.50	-0.58	-0.70/-0.50	-0.57
Japan	-0.136	-0.30/-0.20	-0.13	-0.30/-0.20	-0.14
UK	0.474	0.40/0.60	0.39	0.40/0.60	0.44

10Y. Bond yield

	13/01/2020	Amundi + 6m.	Forward + 6m.	Amundi + 12m.	Forward + 12m.
US	1.84	1.70/1.90	1.90	1.50/1.70	1.96
Germany	-0.17	-0.20/0.00	-0.13	-0.40/-0.20	-0.08
Japan	0.00	-0.10/0.10	0.03	-0.10/0.10	0.06
UK	0.74	0.80/1.00	0.81	0.80/1.00	0.87

Currency outlook

	09/01/2020	Amundi + 6m.	Consensus Q2 2020	Amundi + 12m.	Consensus Q4 2020
EUR/USD	1.11	1.13	1.13	1.14	1.15
USD/JPY	110	107	108	104	107
EUR/GBP	0.85	0.86	0.85	0.86	0.85
EUR/CHF	1.08	1.12	1.11	1.10	1.12
EUR/NOK	9.87	9.79	9.80	9.91	9.70
EUR/SEK	10.54	10.50	10.50	10.44	10.40
USD/CAD	1.31	1.30	1.31	1.26	1.30
AUD/USD	0.69	0.69	0.69	0.70	0.70
NZD/USD	0.66	0.65	0.66	0.67	0.66
USD/CNY	6.93	7.05	7.00	7.10	7.00

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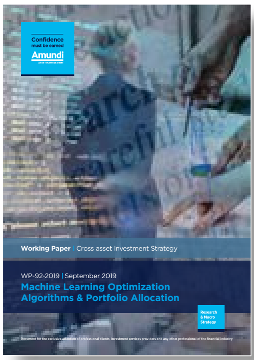

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