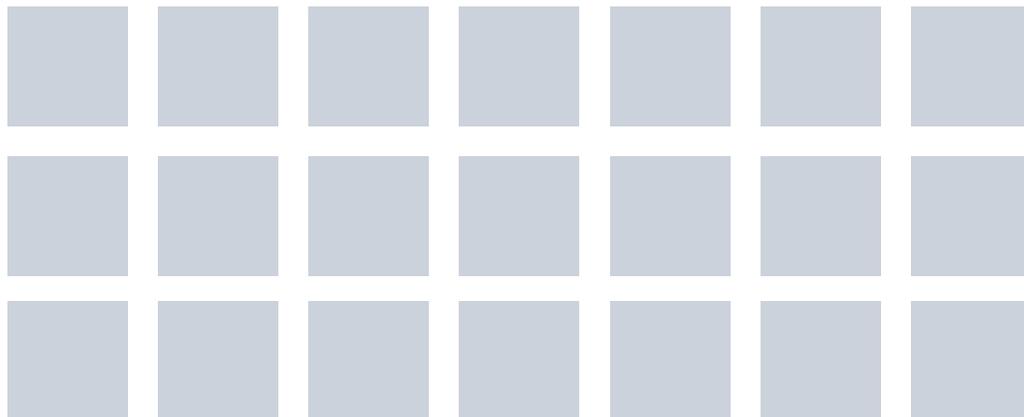


## Investing in the Current Economic Climate



**Amundi**

November 2013

Chris Morris

Merrick Styles



# ECONOMIC CLIMATE

# In a Nutshell – Global Macro Themes

- Global growth is firming. The U.S. growth outlook remains constructive and China is settling onto a moderate growth path.
- Japan has made significant first policy steps towards ending two decades of deflation. First signals from the economy are promising but the road to success will be long and winding.
- Mario Draghi’s “crisis firewall” has changed the complexion of the EZ crisis.
- Easier global financial conditions have laid the foundation for a cyclical growth rebound.
- Global monetary policy looks set to remain accommodative. However, **the point of maximum monetary ease has been passed**, as “taper” is still on the way.
- There are few signs of rising inflation pressure. Inflation expectations remains anchored and excess capacity remains ample.

# In a Nutshell – Investment Themes

## ■ Global Themes

- Global risk appetite likely to stay supported
- Macro strategies will continue to dominate but directional strategies will increasingly be replaced by RV
- Risk-On/Risk-Off is not yet overcome even though its dominance has receded

## ■ Government Bonds

- Negative on duration, particularly in the US and Japan
  - When safe-havens stop being safe!
  - But lack of inflation will limit the potential damage to bond investors
- Expect flatter yield curves in the medium term
- Peripheral Debt: As the EZ exits systemic crisis the prospects for tighter spreads are increasing.

# Global Outlook – Now-Casting

## NOW-CASTING 14/10/13 (B) Calendar Quarters

— Q3 2012  
— Q4 2013  
— Q1 2014

Chart 1: US (% QoQ)

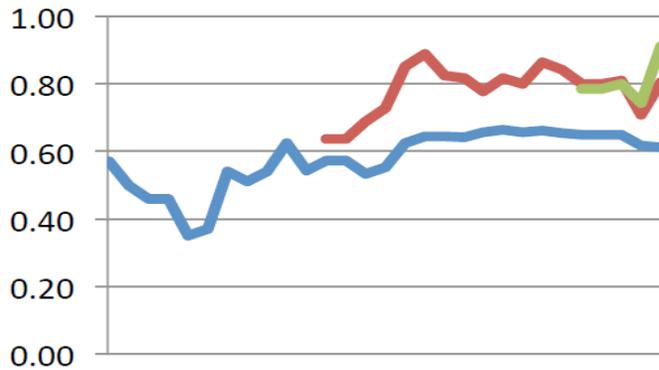


Chart 2: Euro Area (% QoQ)

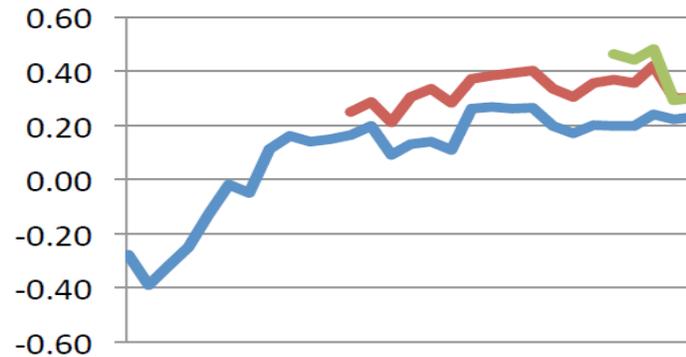


Chart 7: UK (% QoQ)

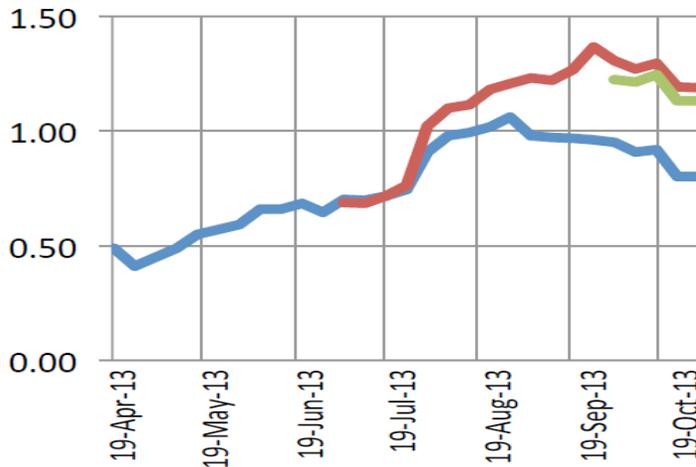
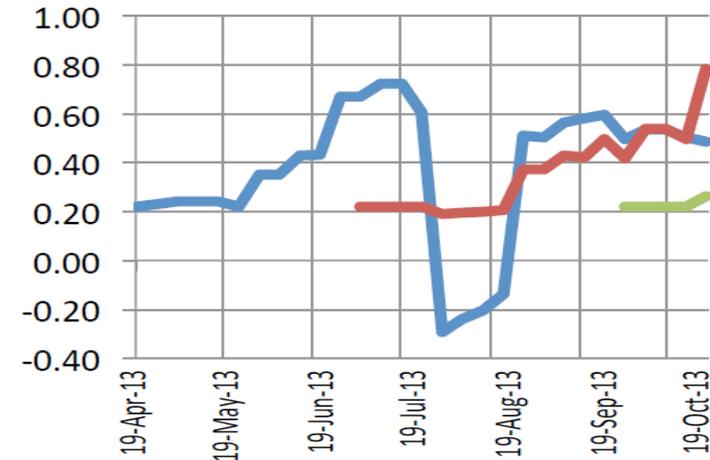


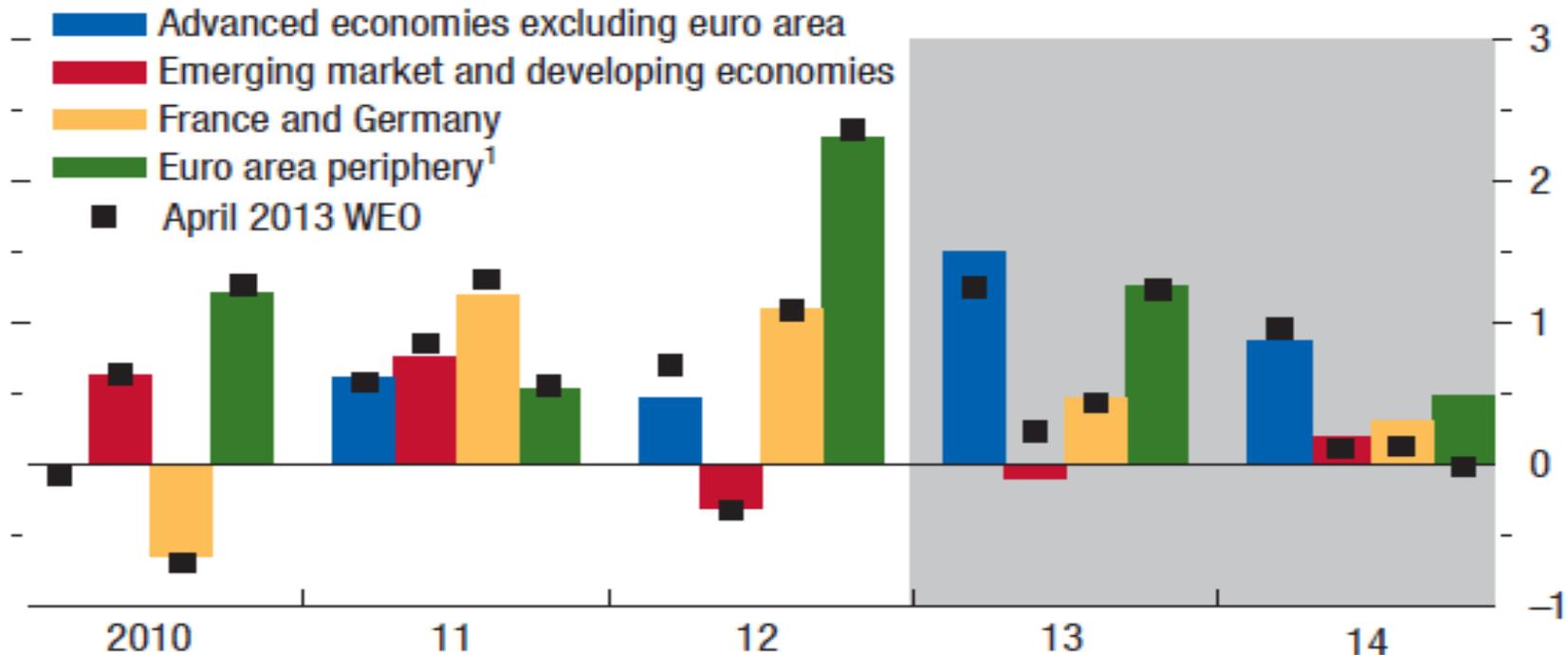
Chart 9: Japan (% QoQ)



# Global Outlook – Fiscal Impulse

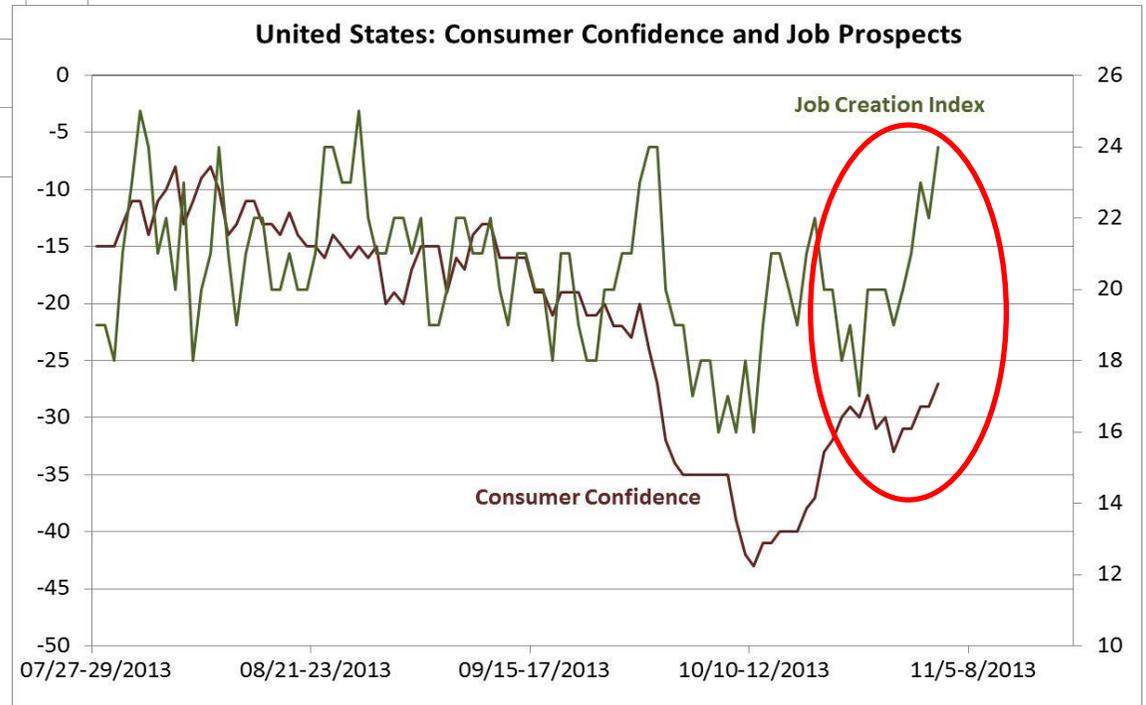
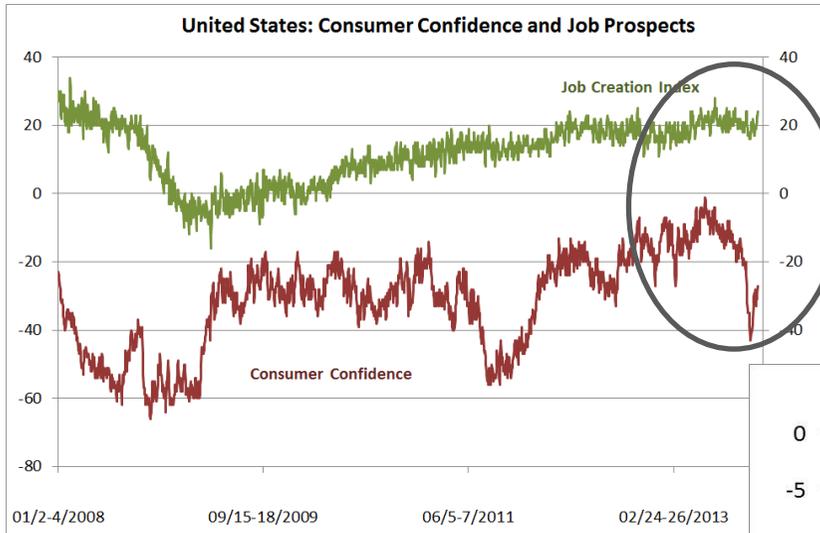
## 1. Fiscal Impulse

(change in structural balance as percent of GDP)



Fiscal policy will tighten less in the advanced economies in 2014 and stay broadly neutral in emerging market and developing economies. Among advanced economies, the pace of tightening will fall off appreciably in the euro area and the United States. However, this will be partly offset by tightening in Japan. Public debt will remain very high in the advanced economies in the medium term, while declining to about 30% of GDP in the emerging market and developing economies.

# Global Outlook – Impact of U.S. Shutdown



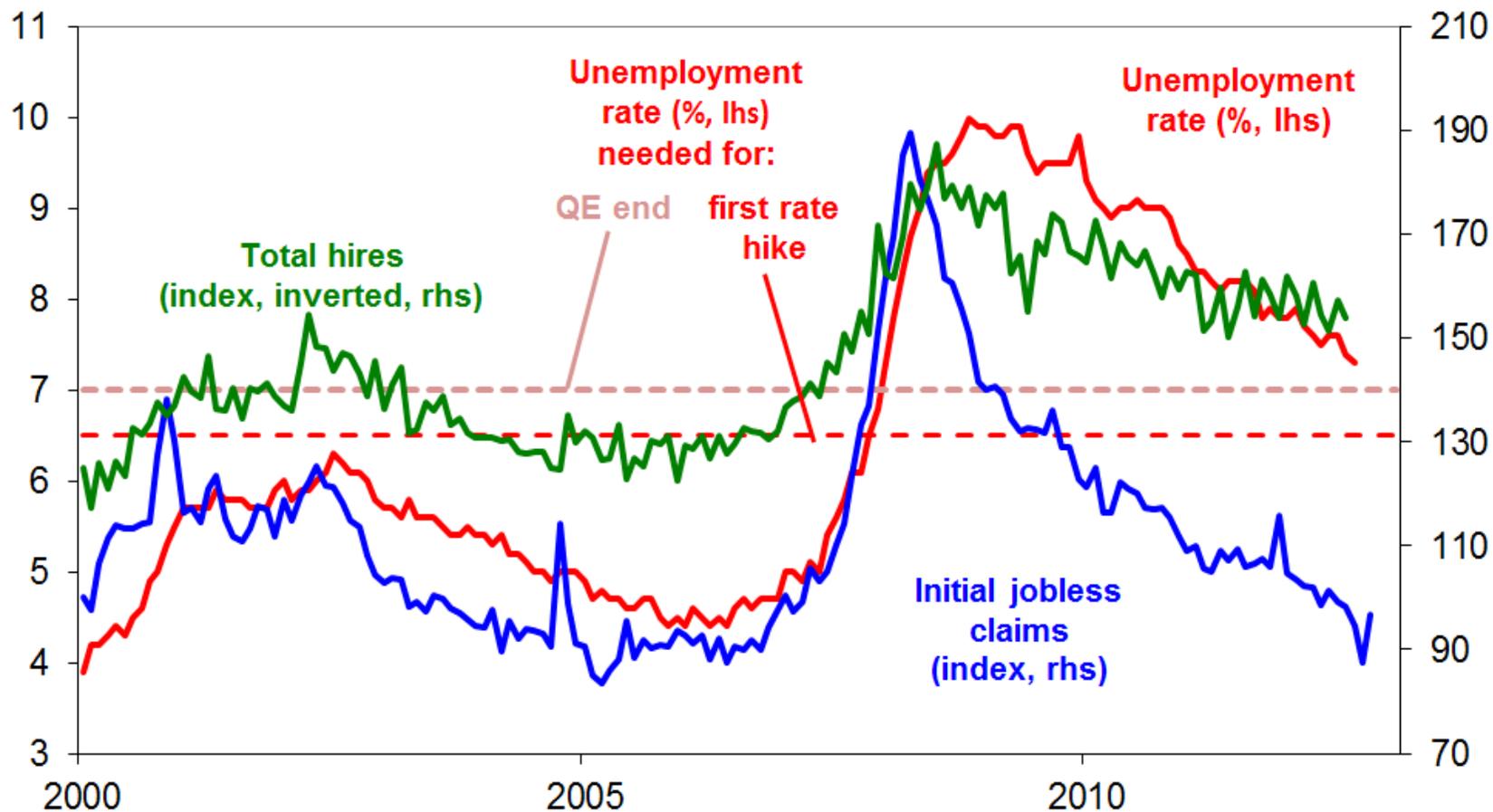
# Global Outlook – Impact of U.S. Shutdown

A brief shutdown has minor macroeconomic effects.

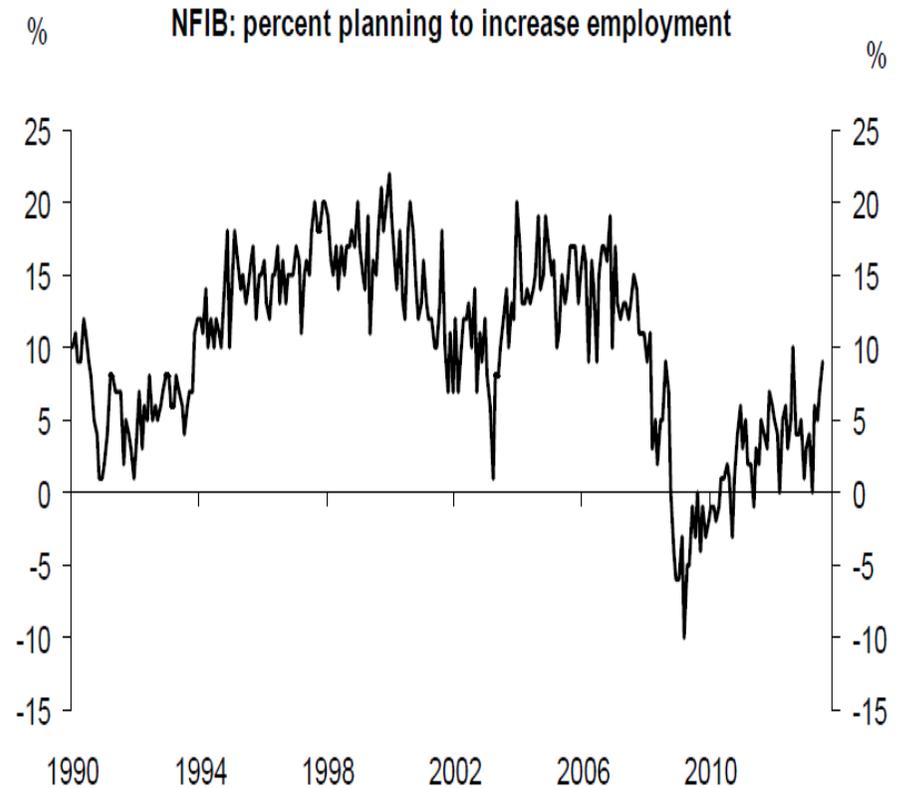
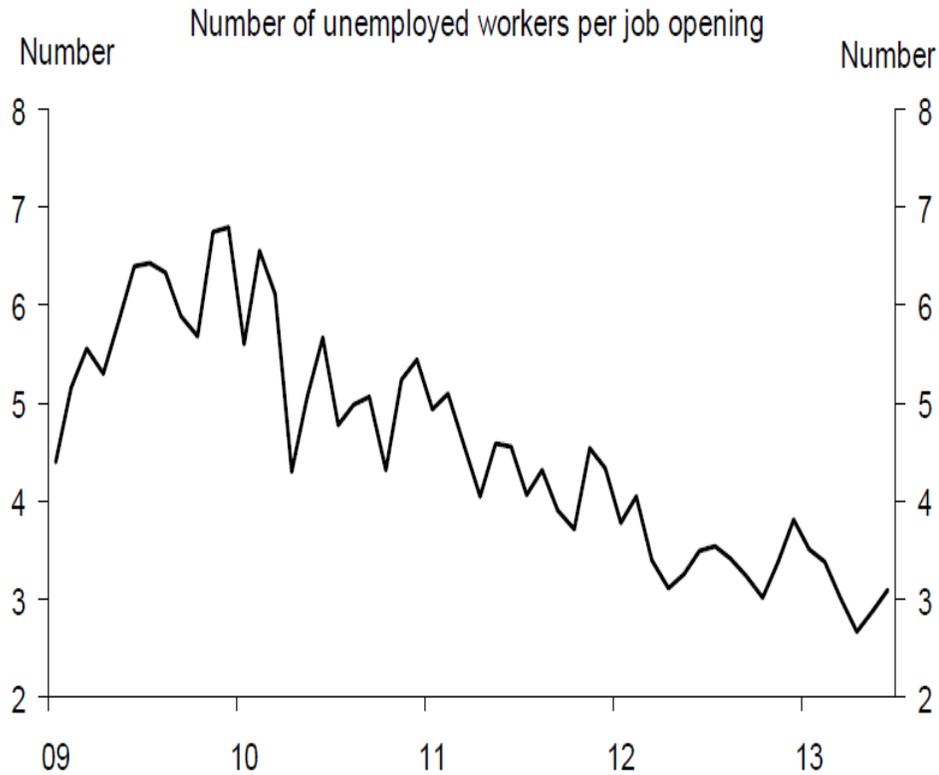
	Quarterly spending, \$bn Ann. Q3 2012	Effect of Shutdown Scenarios (\$bn, annualised)		
		2-Day	7-Day	21-Day
Civilian Compensation	278.5	-2.4	-8.6	-25.7
Services	375.5	0.0	-2.9	-34.7
Goods	107.1	0.0	0.0	-2.5
Investment	155.0	0.0	0.0	-3.6
<b>Total Potentially Affected Areas</b>	916.1	-2.4	-11.5	-66.4
<b>% of GDP</b>	5.7%	-0.02%	-0.1%	-0.4%
<b>Growth Effect (pp)</b>		-0.1	-0.3	-1.6

# U.S. Labour Market Trends

## U.S. Labour Market Trends

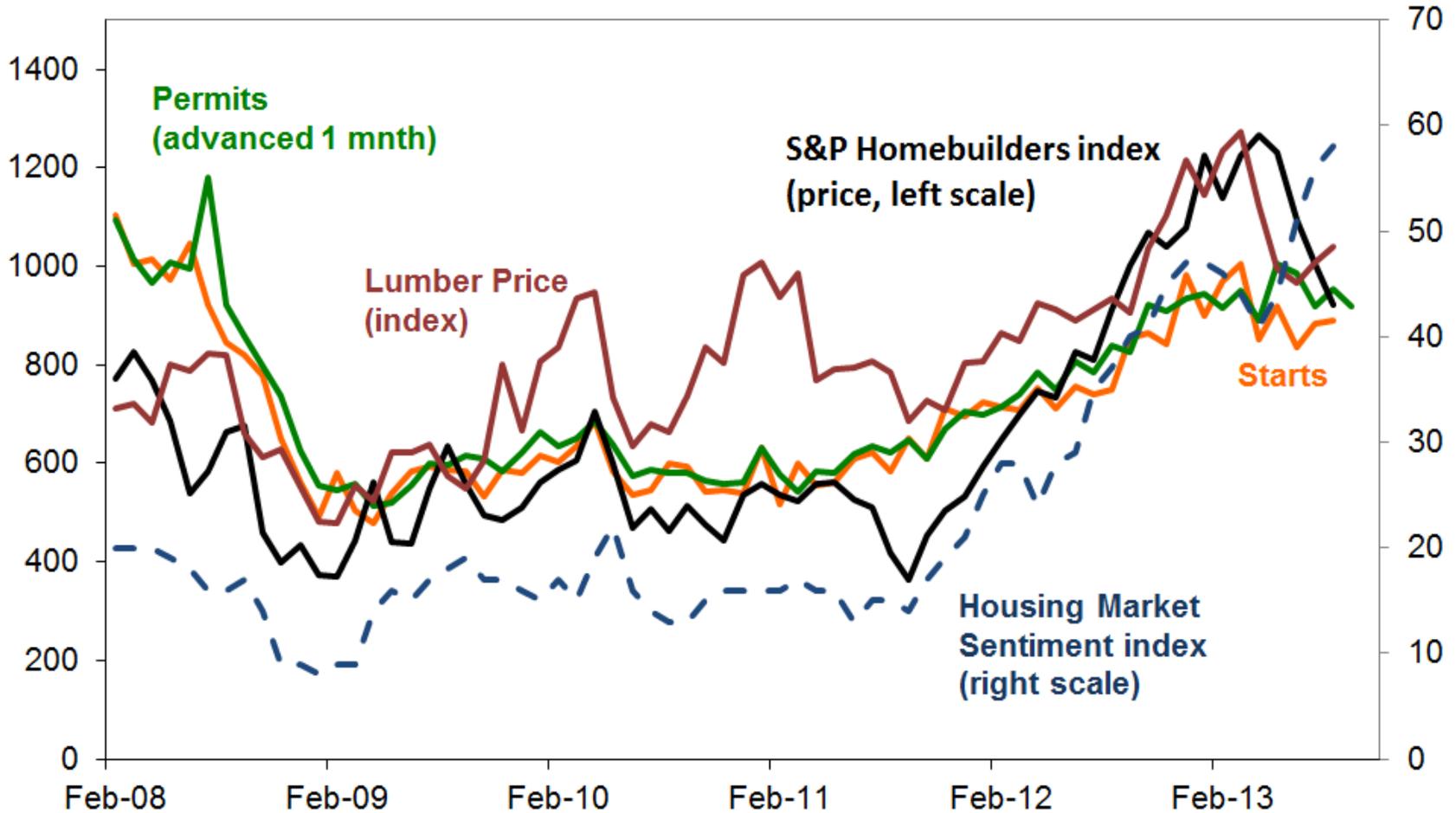


# U.S. Labour Market Trends



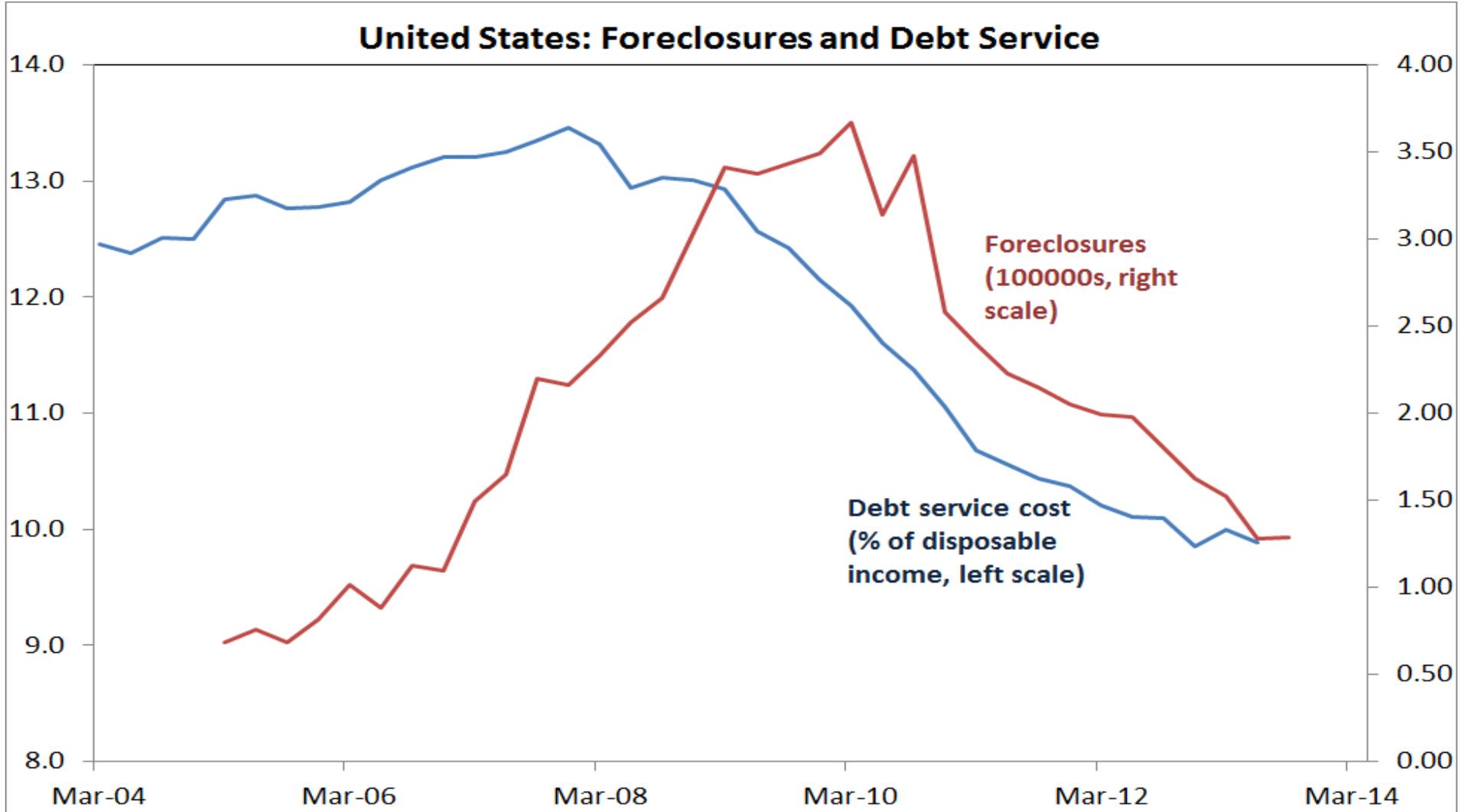
# U.S. Housing

United States: Housing Starts and Permits (000s) and Homebuilder equities



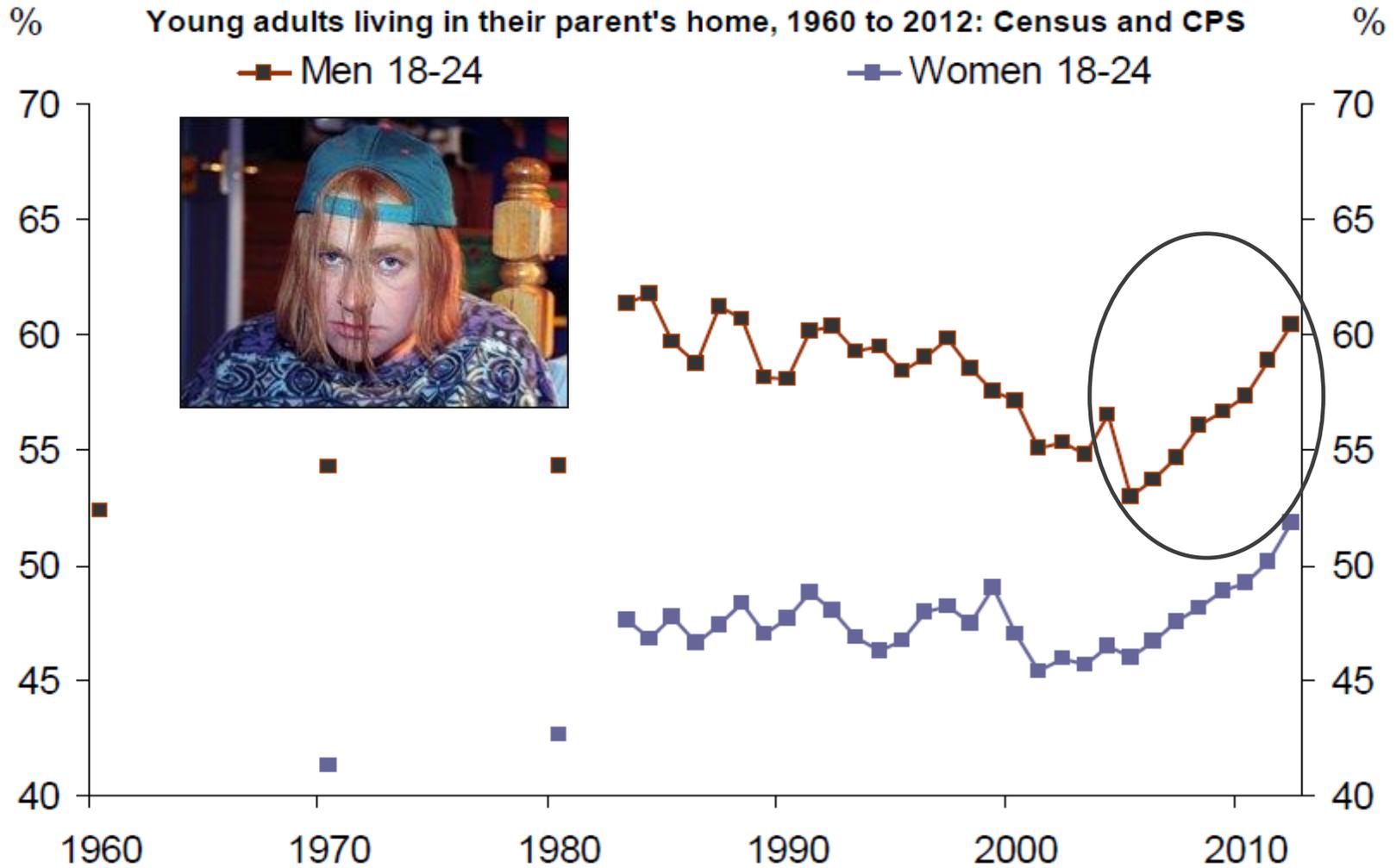
Source: Amundi and Bloomberg.

# U.S. Housing



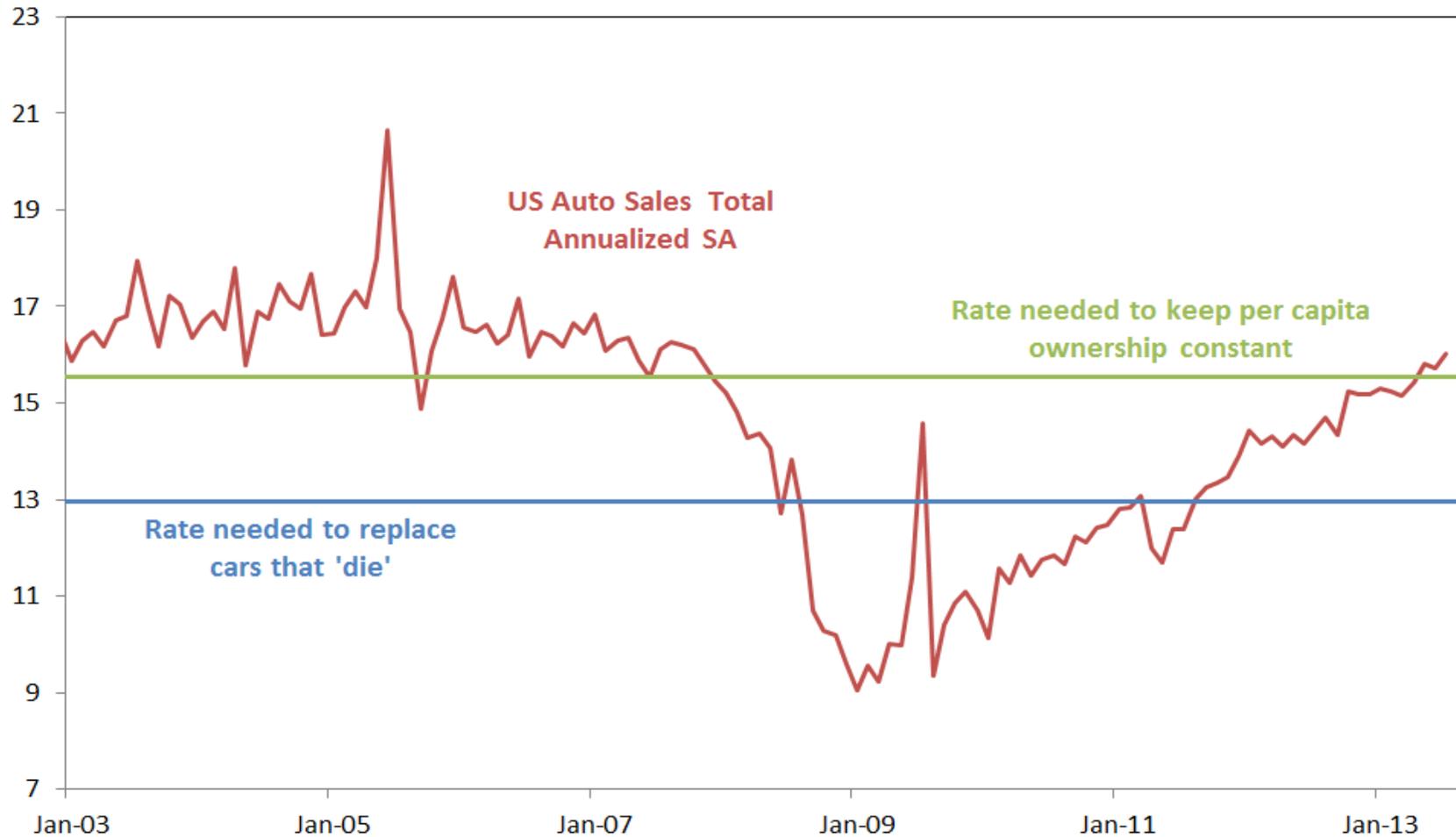
Source: Amundi and Bloomberg.

# U.S. Housing – Pent-Up Demand

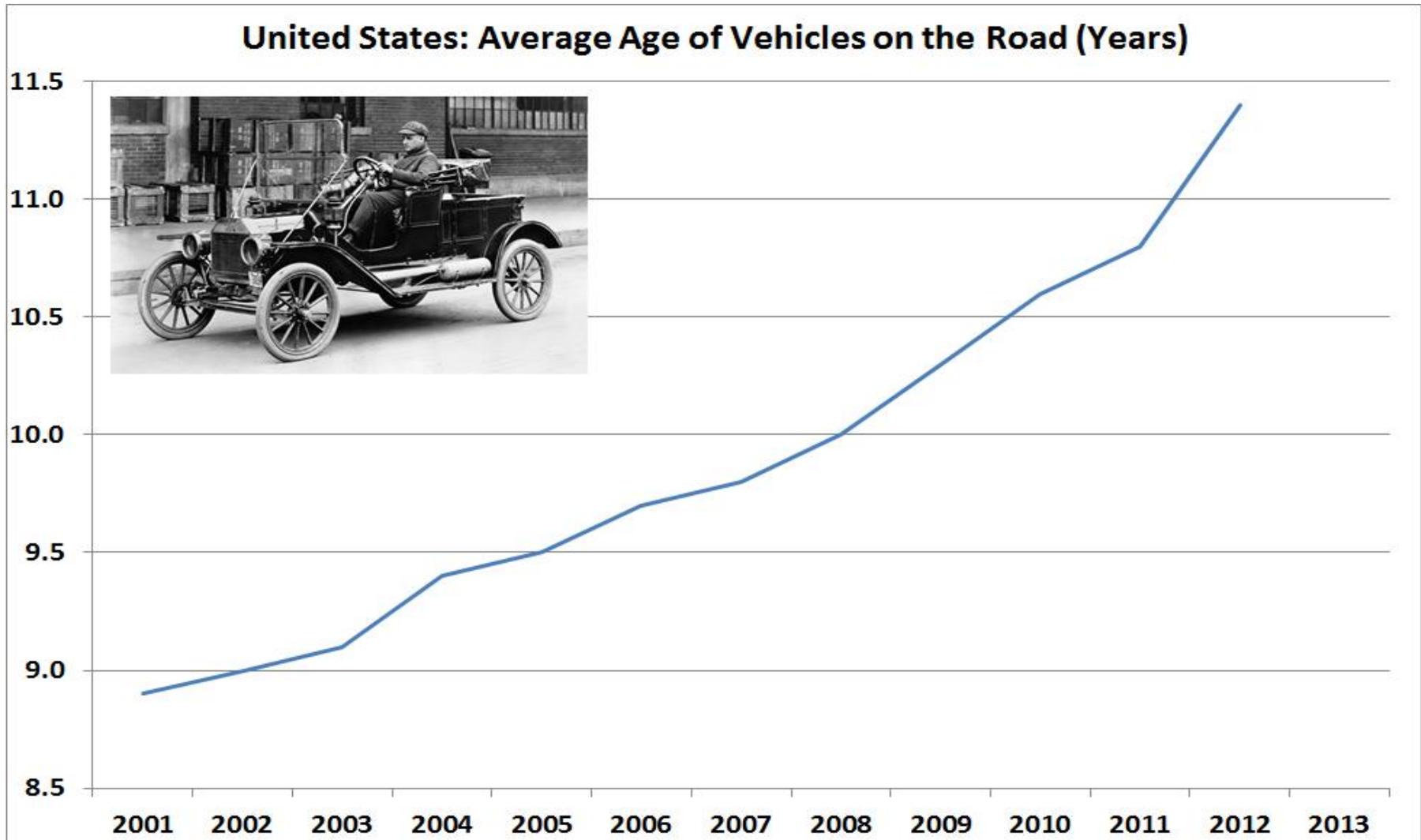


# U.S. Autos – Pent-Up Demand

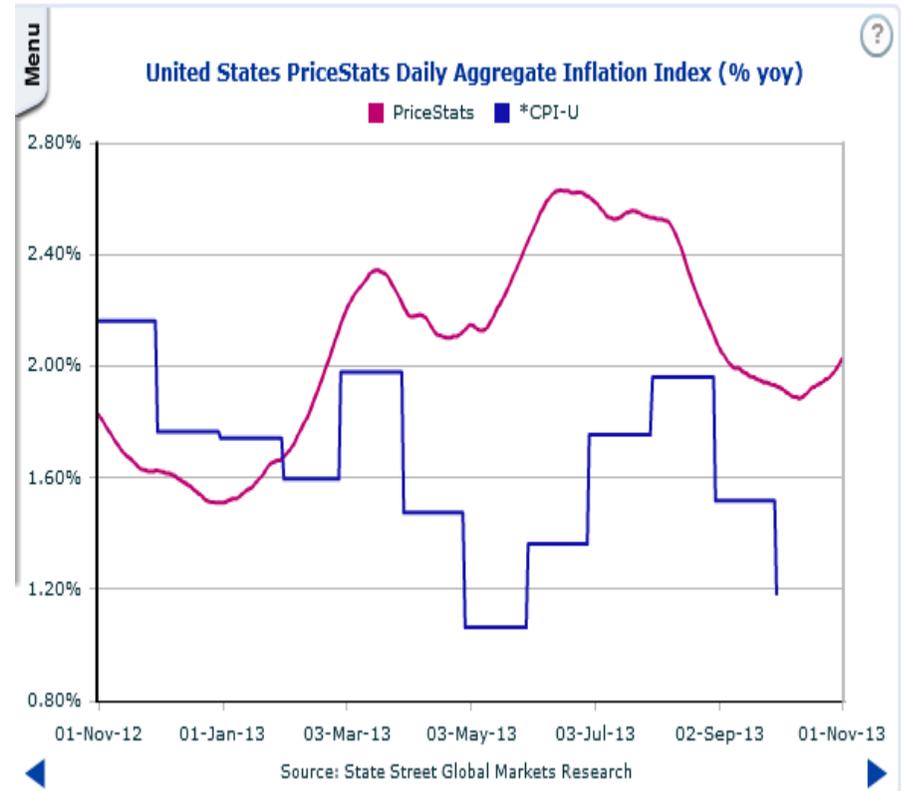
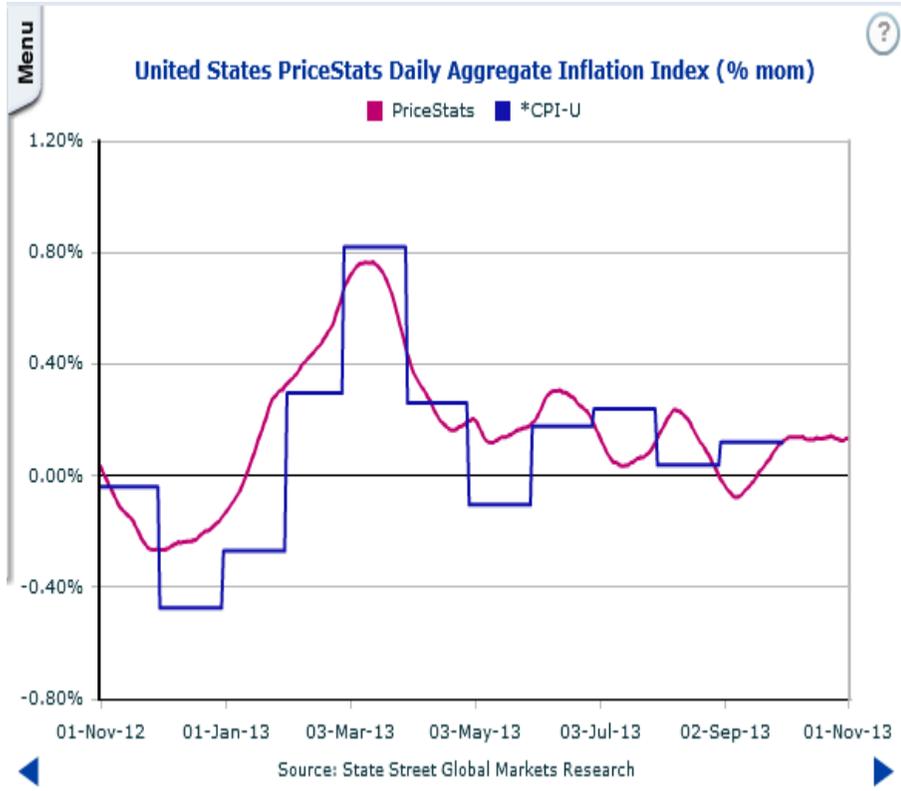
U.S. Car and light truck sales (millions, annualized)



# U.S. Autos – Pent-Up Demand

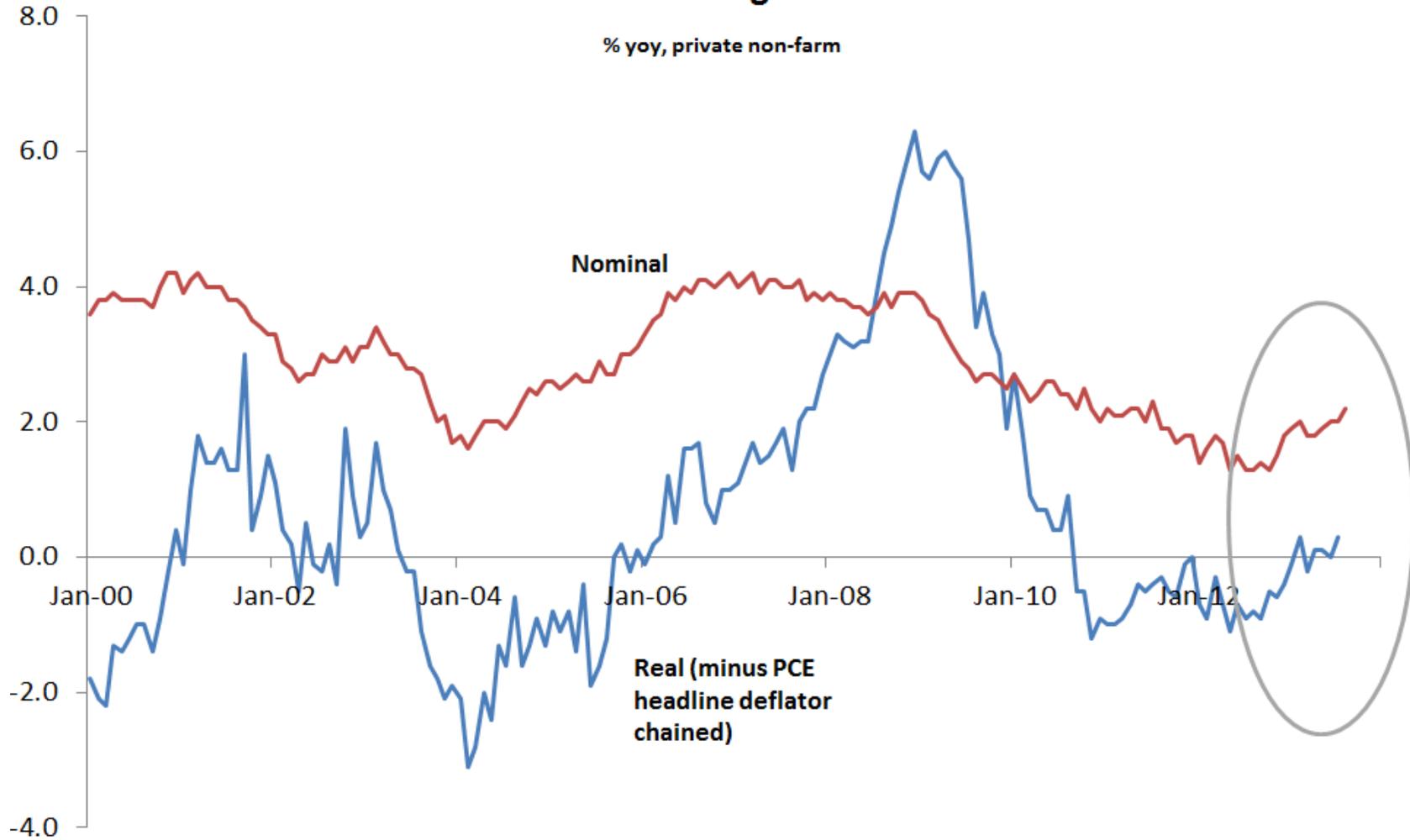


# U.S. Inflation

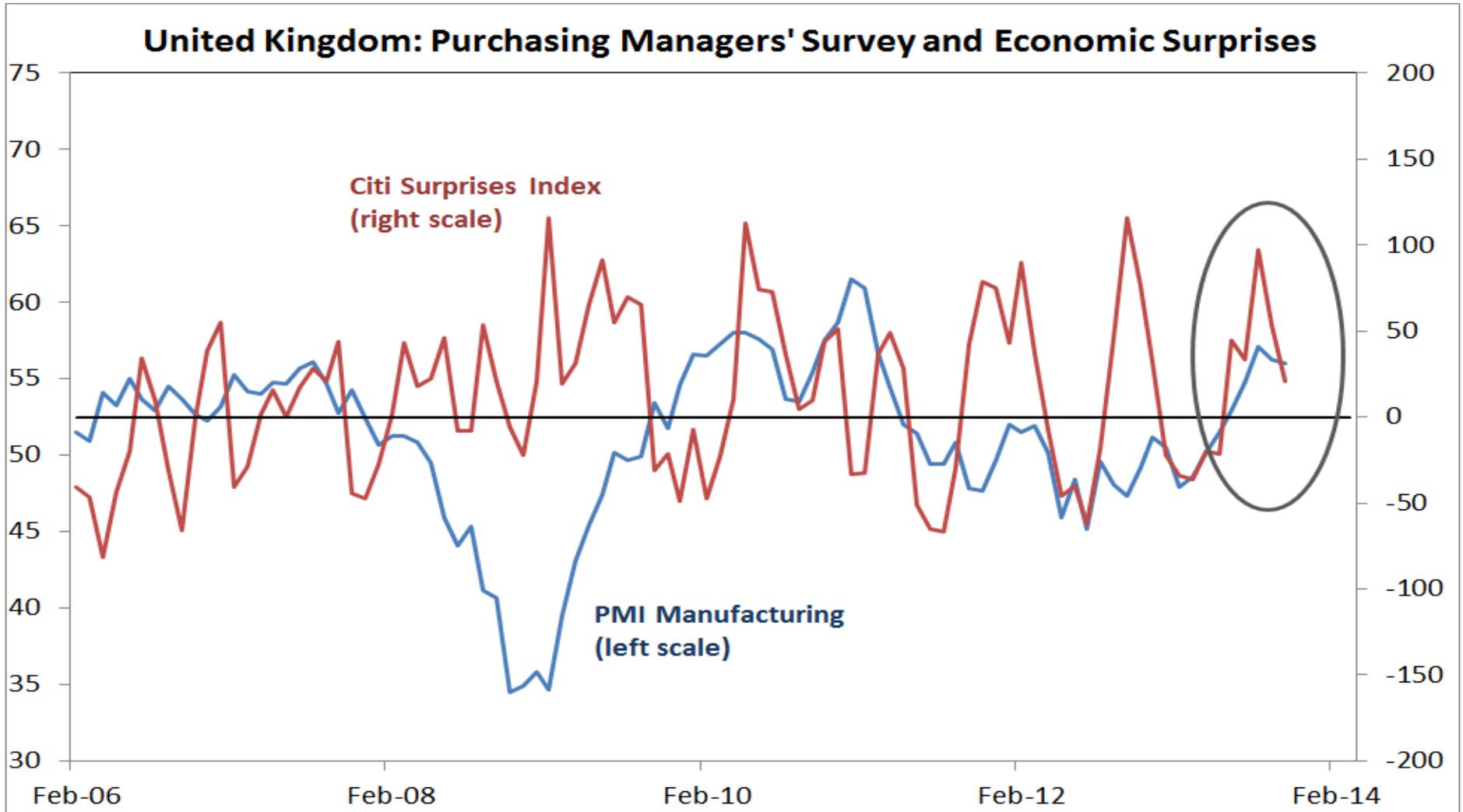


# U.S. Inflation

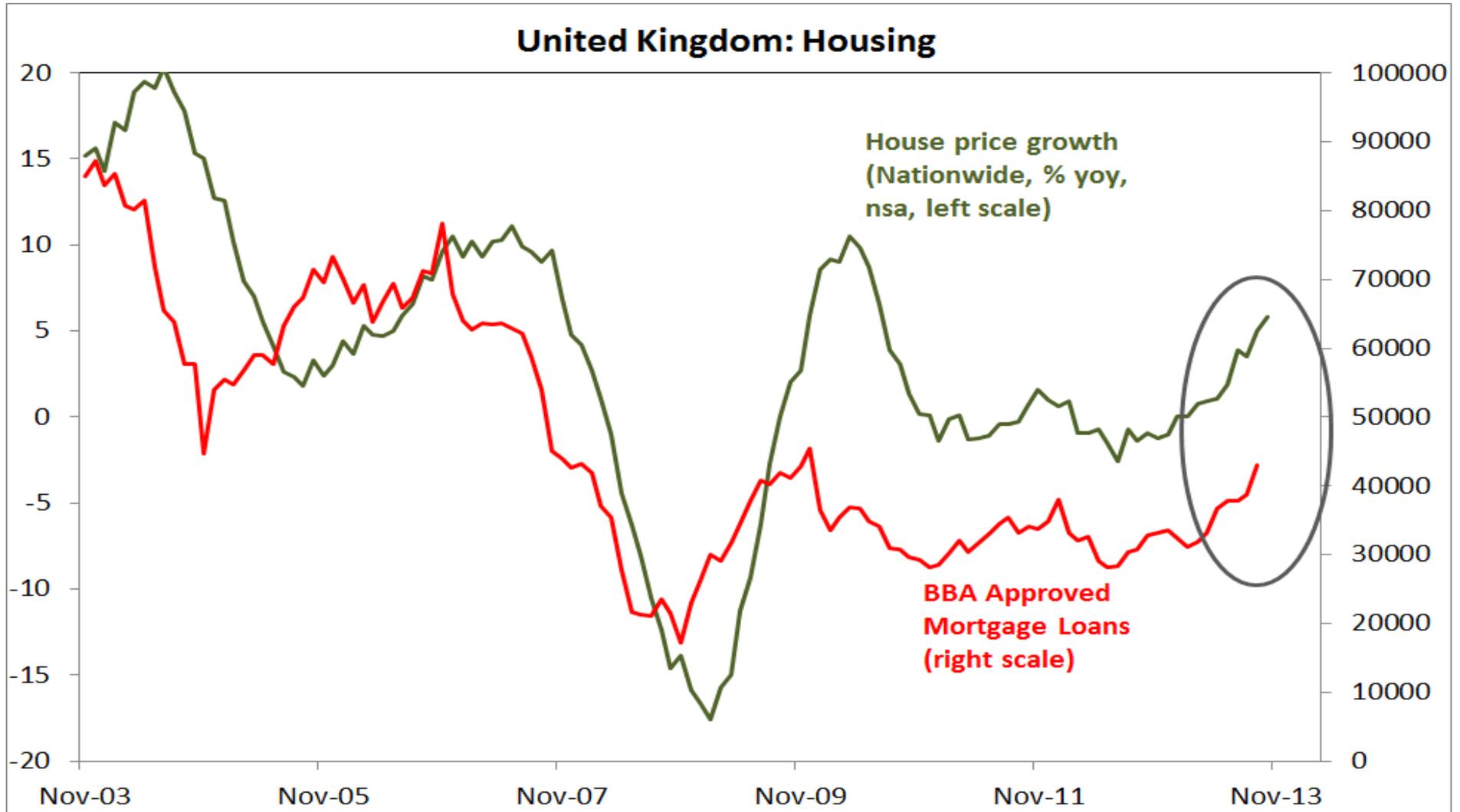
## U.S. Private Wage Inflation



# United Kingdom

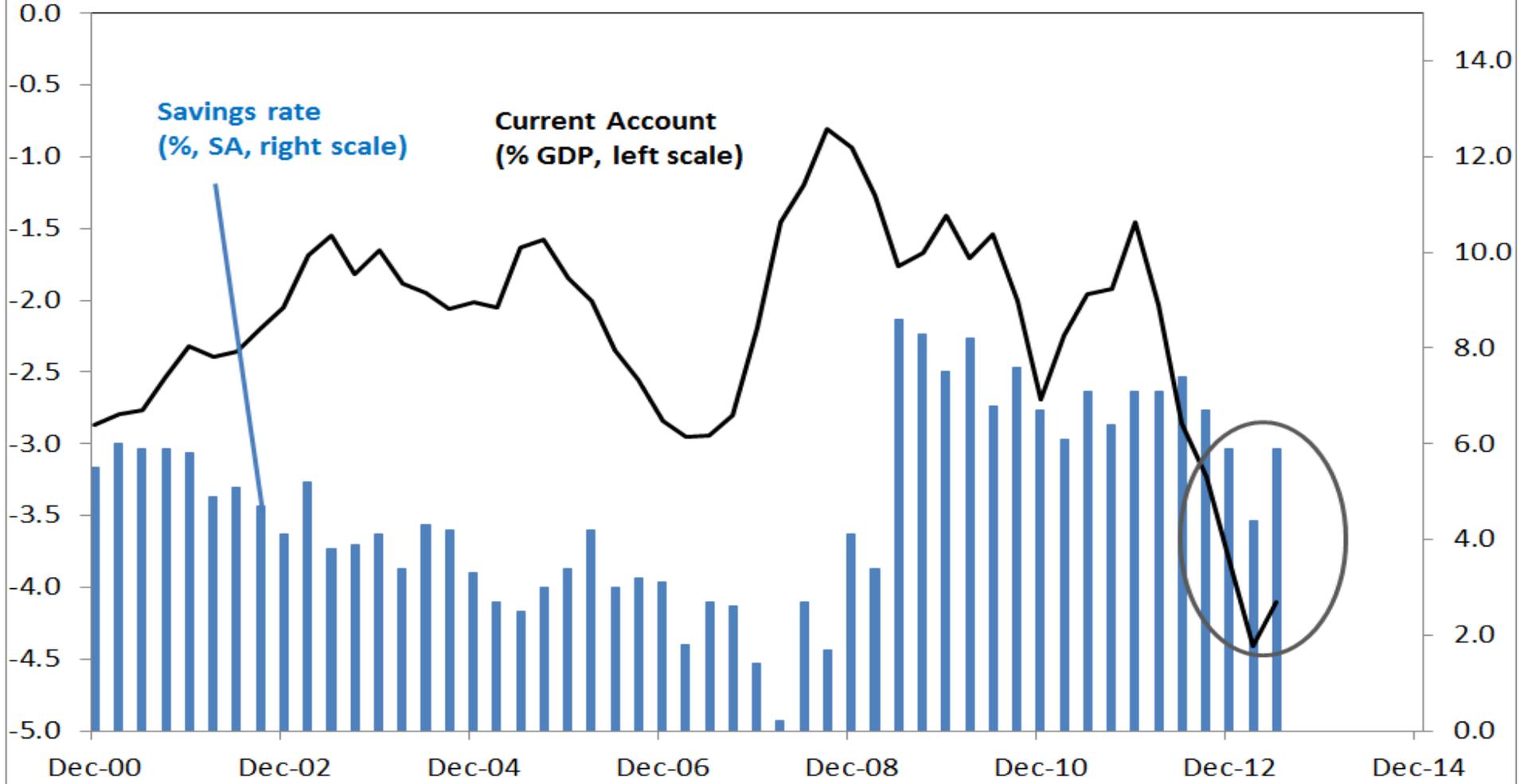


# United Kingdom



# United Kingdom

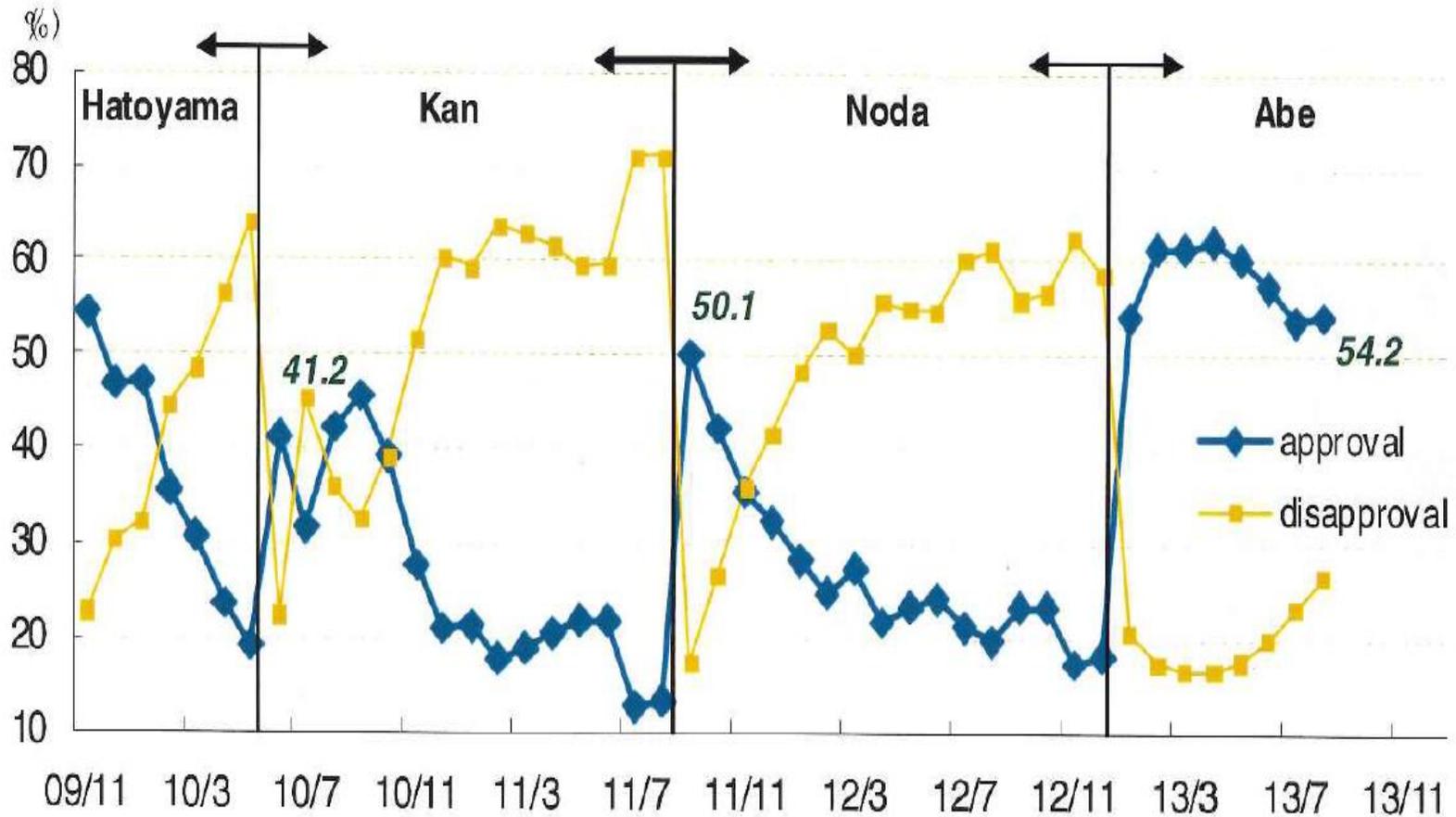
United Kingdom: Savings



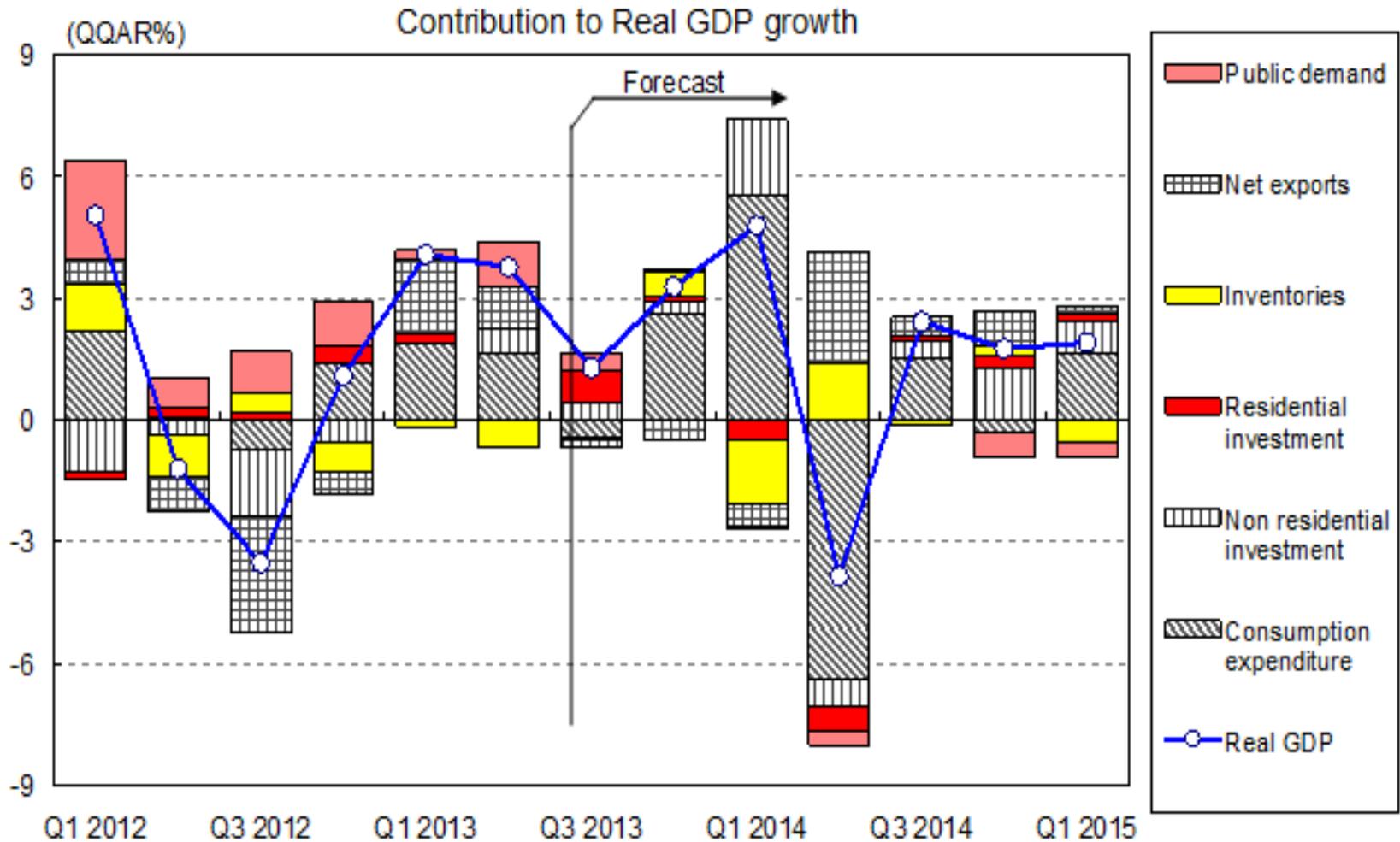
Source: Amundi and Bloomberg.

# Japan – Abenomics is Working

Cabinet approval ratings

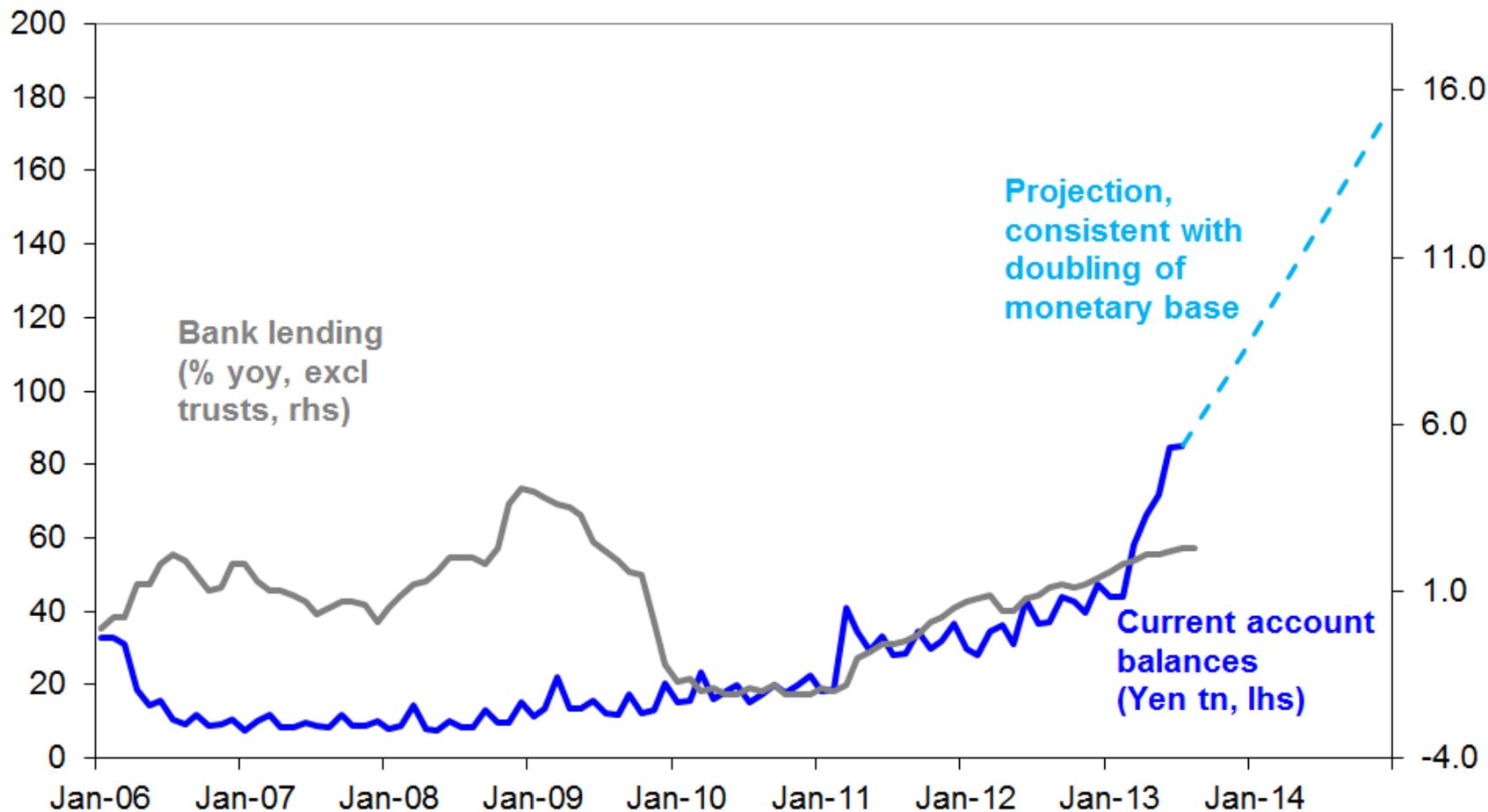


# Japan – Abenomics is Working



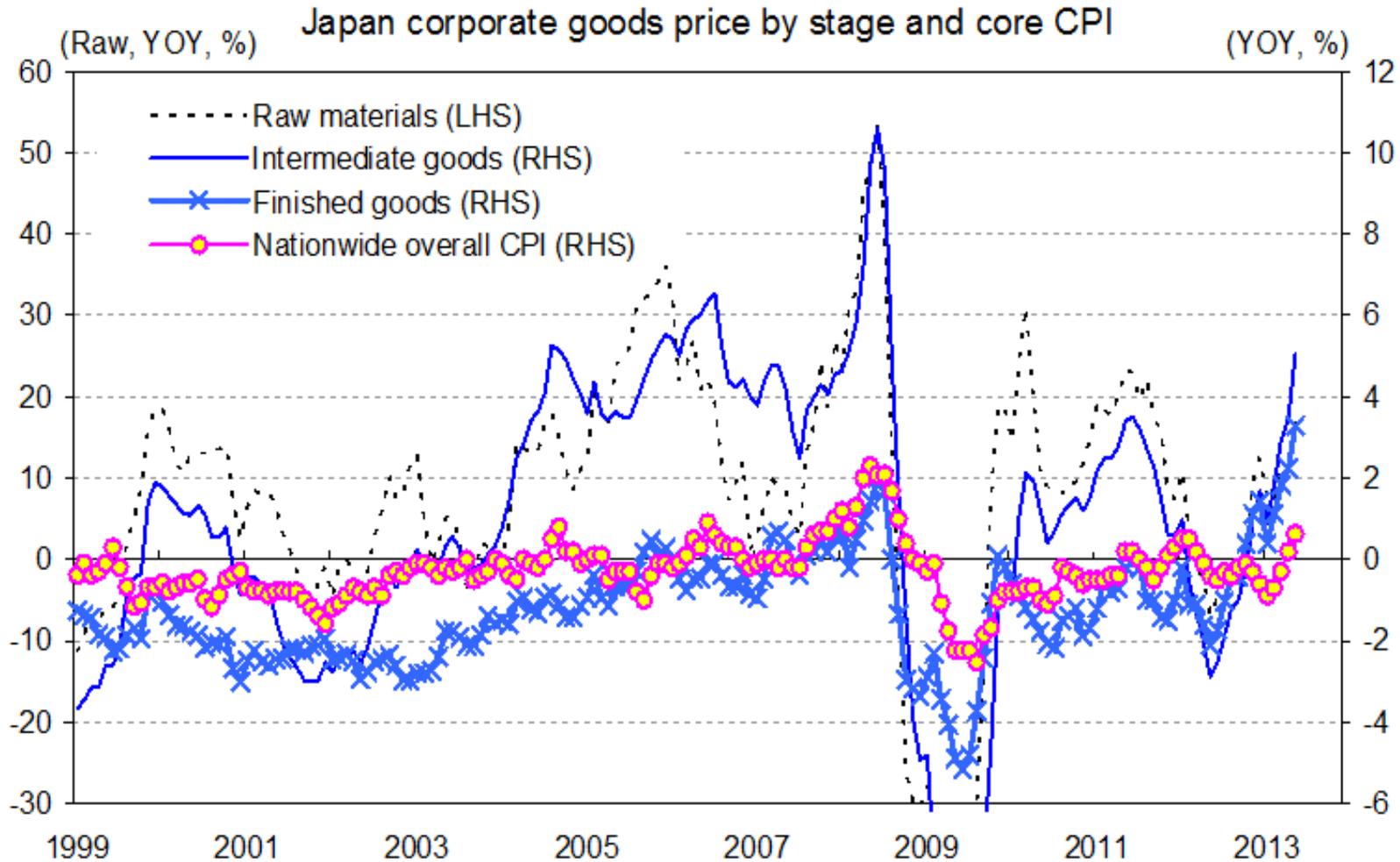
# Japan – Abenomics is Working

Japan: Commercial bank balances at BoJ and bank lending

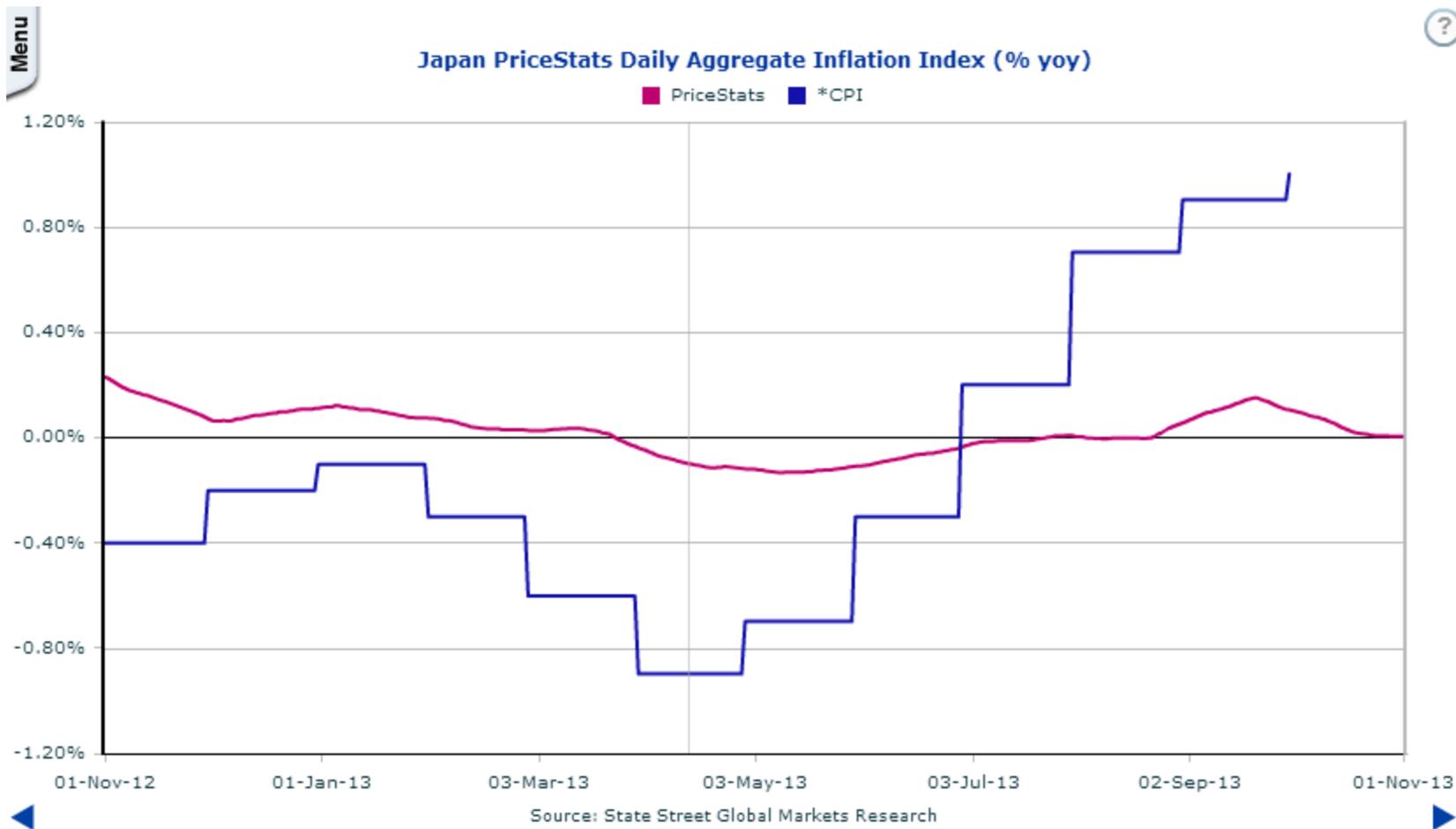


Source: Amundi, Bank of Japan and Bloomberg.

# Japan – Abenomics is Working

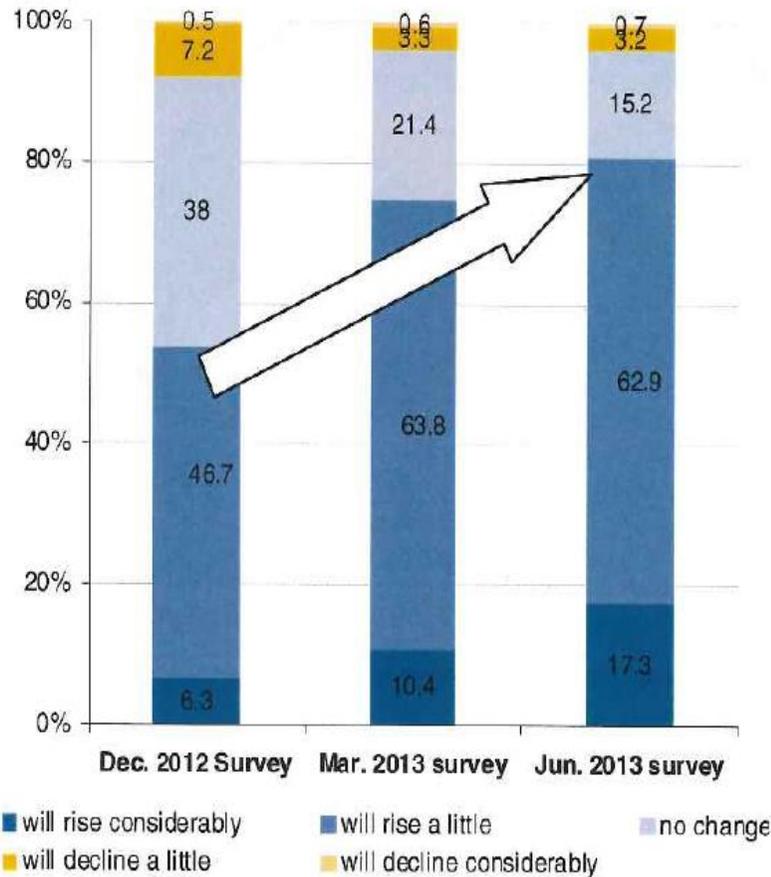


# Japan – Abenomics is Working

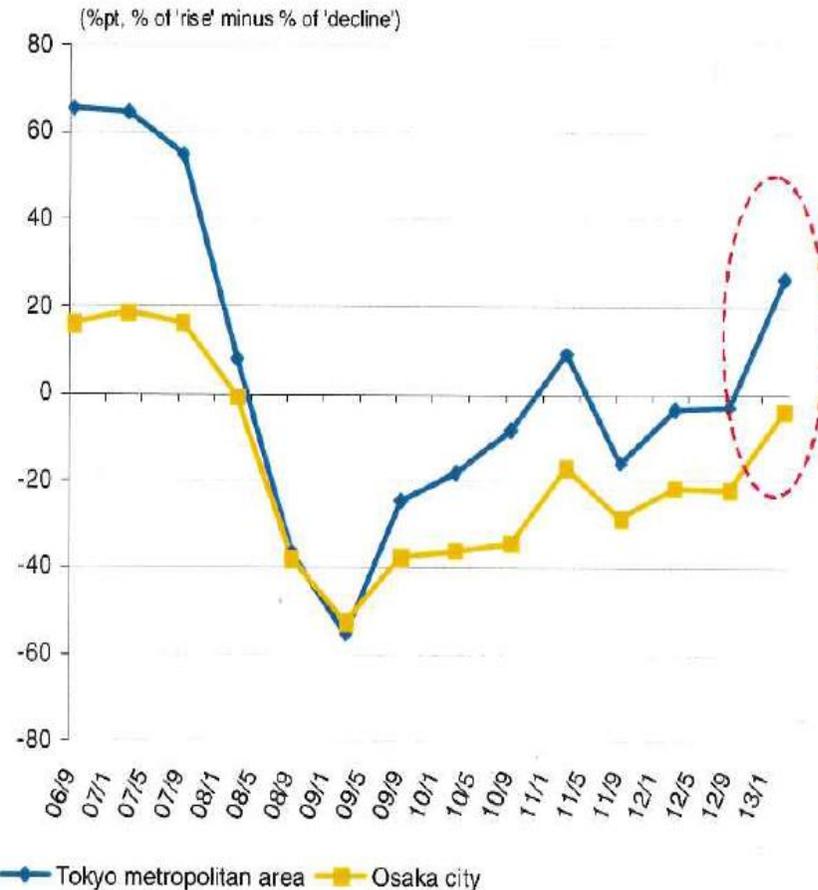


# Japan – Abenomics is Working

Households' responses to the BoJ survey 'What are your expectations for price conditions in one year?'

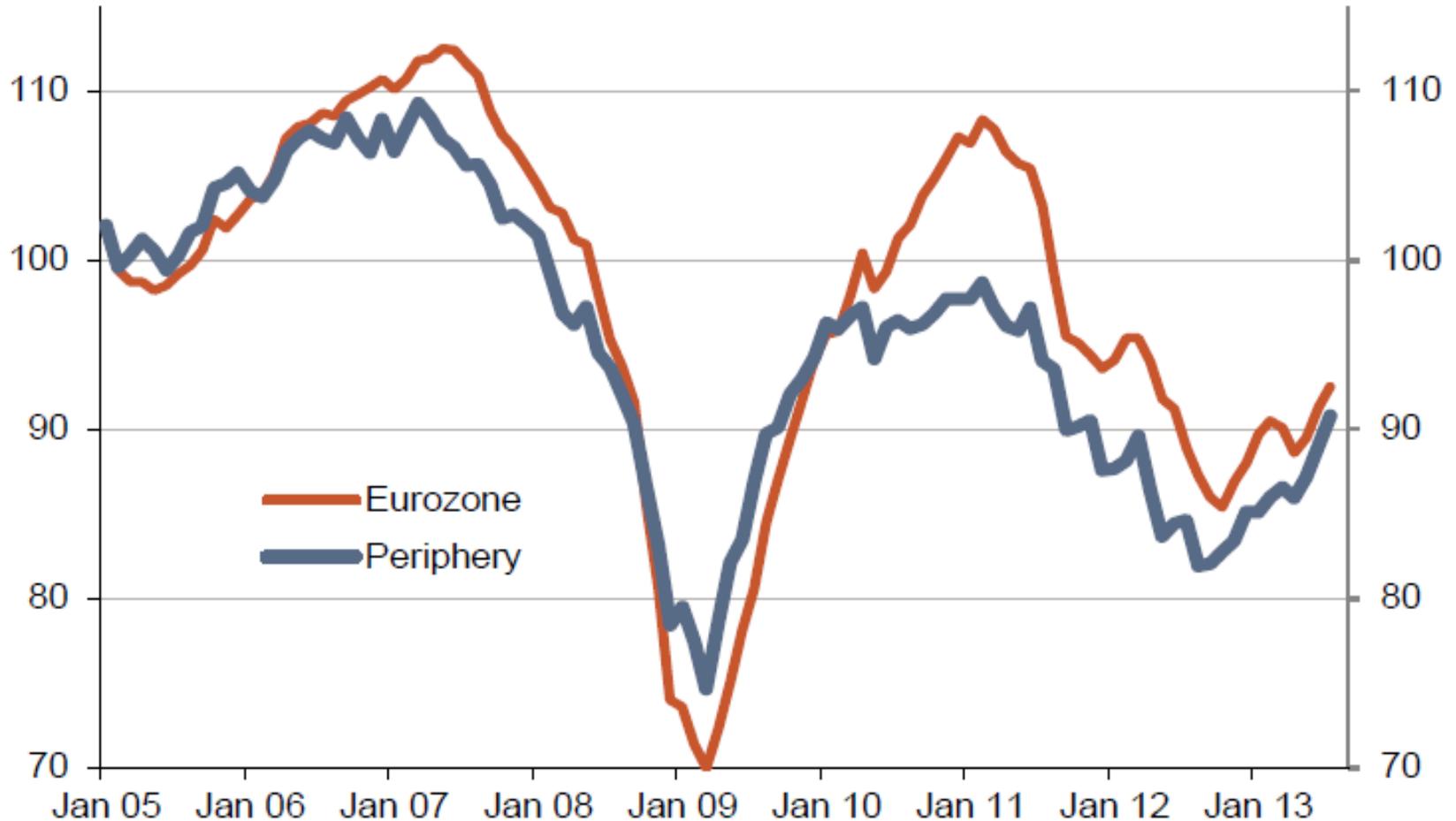


Net % of respondents expecting a rise in property prices



# Eurozone – Steady improvement

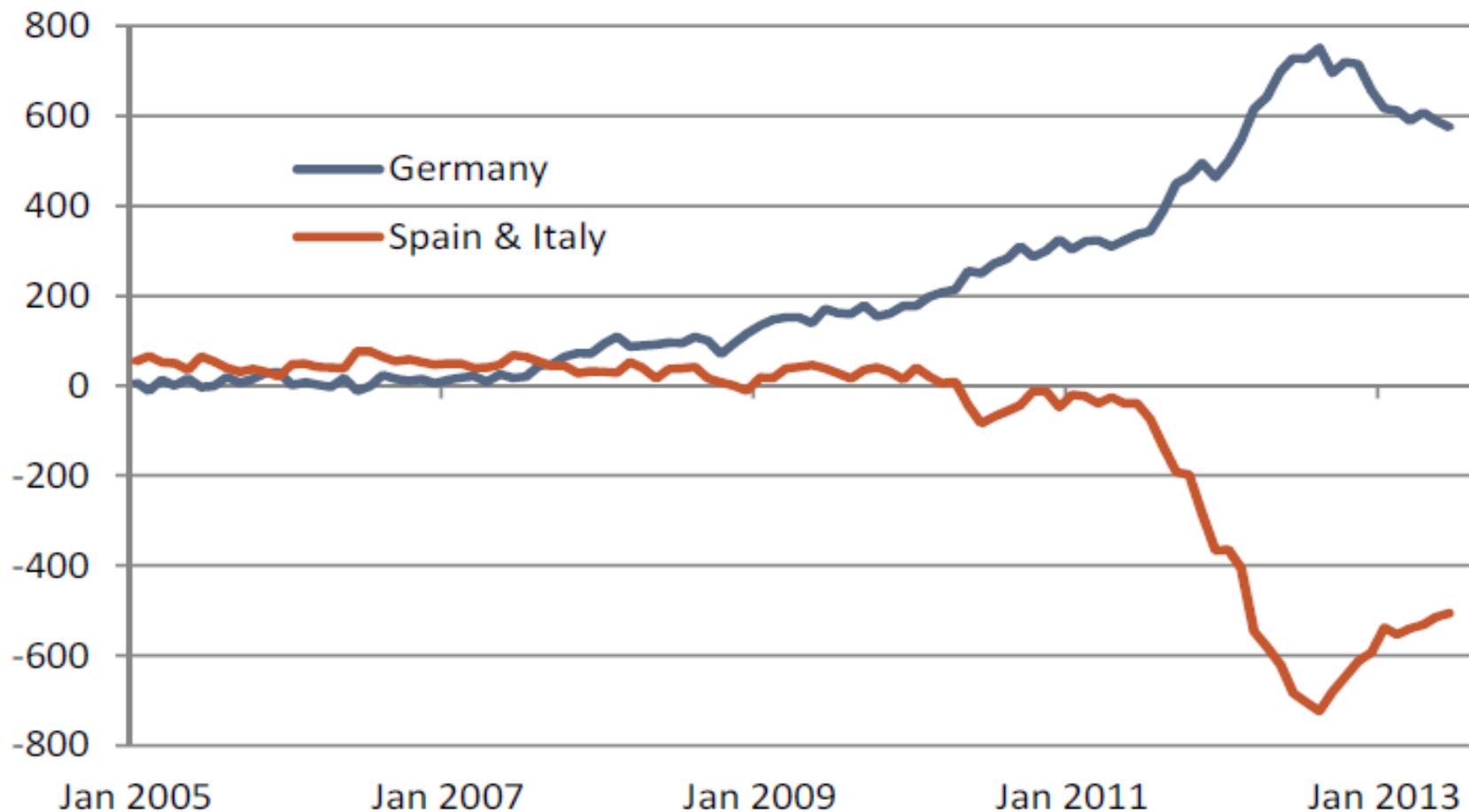
Chart 1: Economic sentiment, the periphery is catching up fast



Source: Berenberg Bank, EU Commission. Periphery: weighted average for Italy, Spain, Portugal and Greece

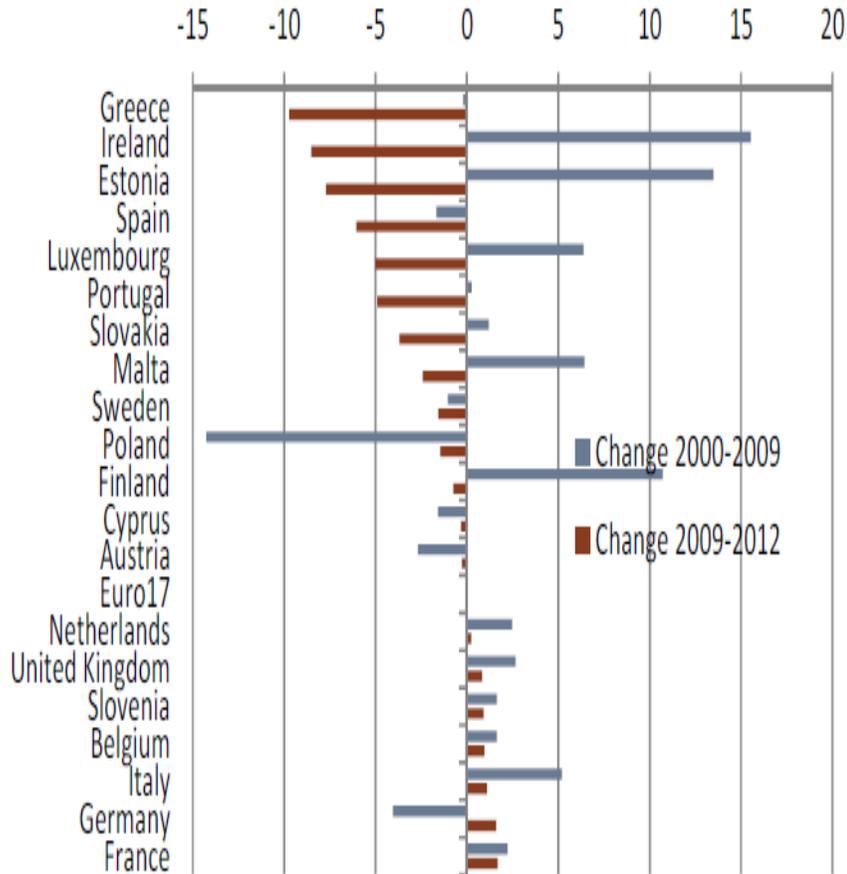
# Eurozone – Steady improvement

## TARGET2 balances

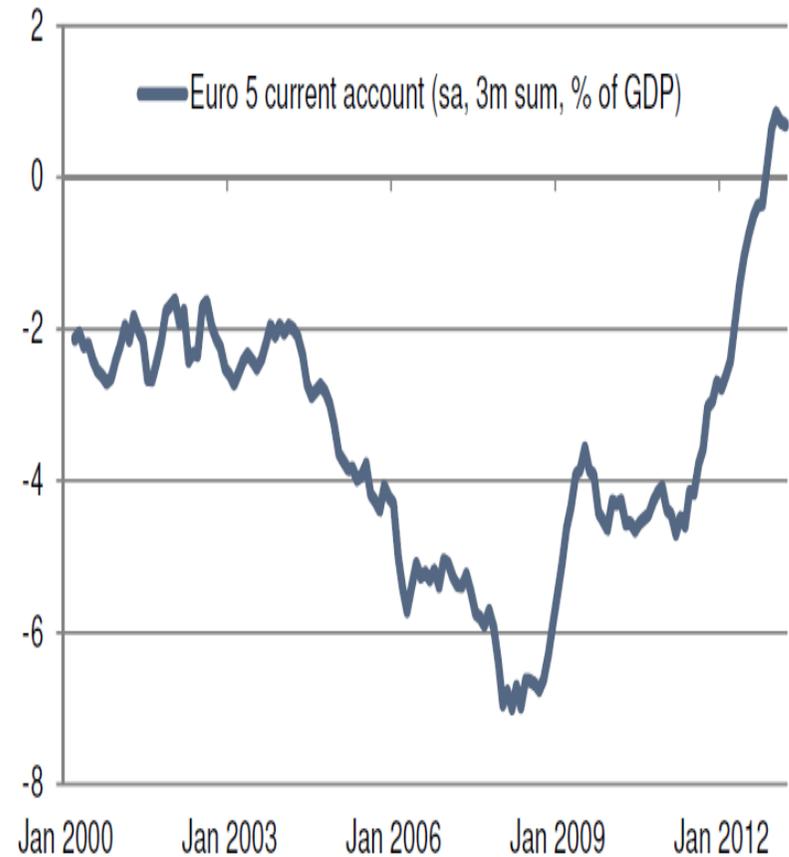


# Eurozone – Steady improvement

Real ULC adjustment 2009-2012



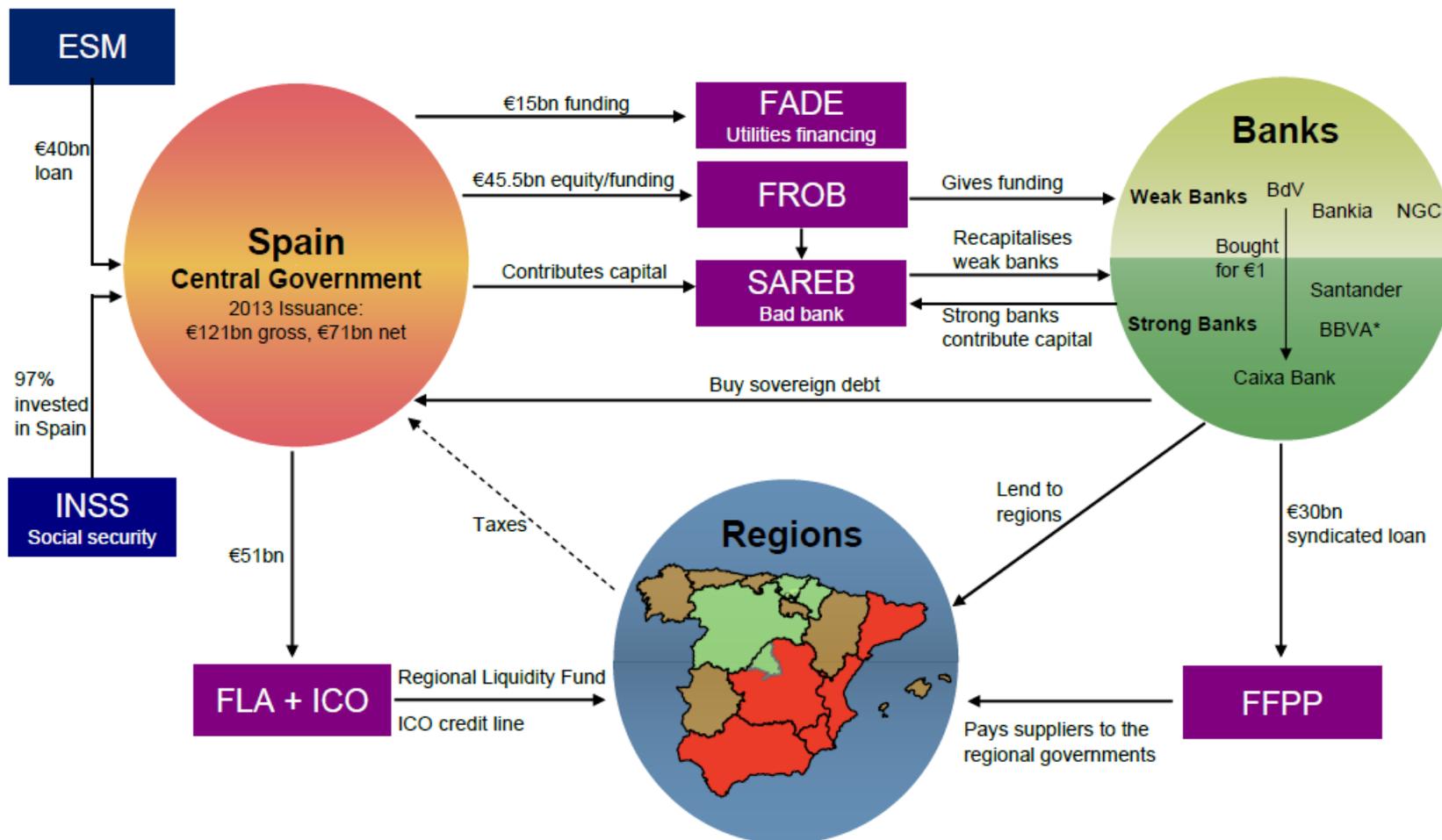
Euro periphery: current account balance



Current account balance in % of GDP, Italy, Spain, Greece, Portugal and Ireland; 3-month moving average. Source: Eurostat, Berenberg calculations

# Eurozone – Steady improvement

Spain: I buy your debt, you buy mine – it works, for now...

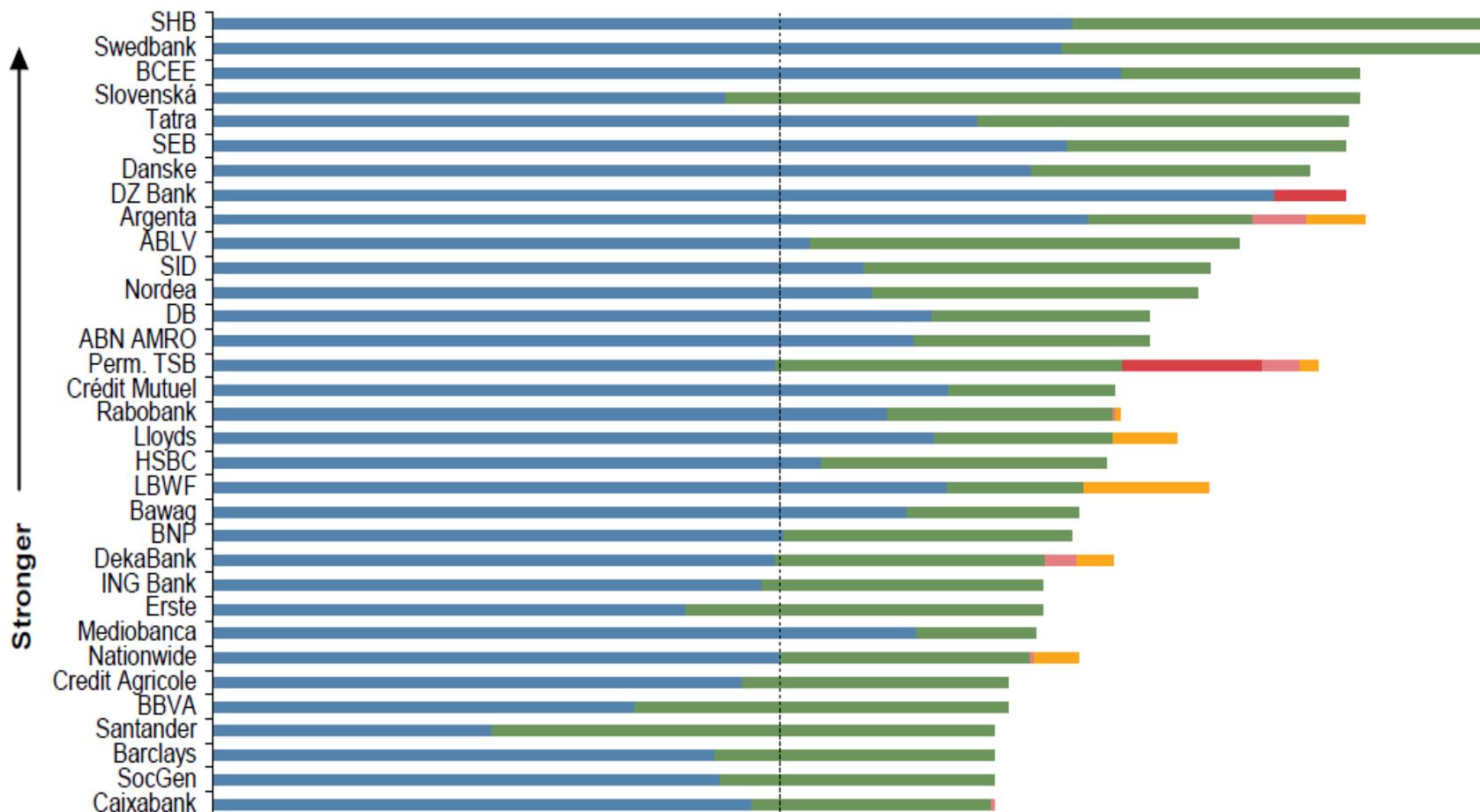




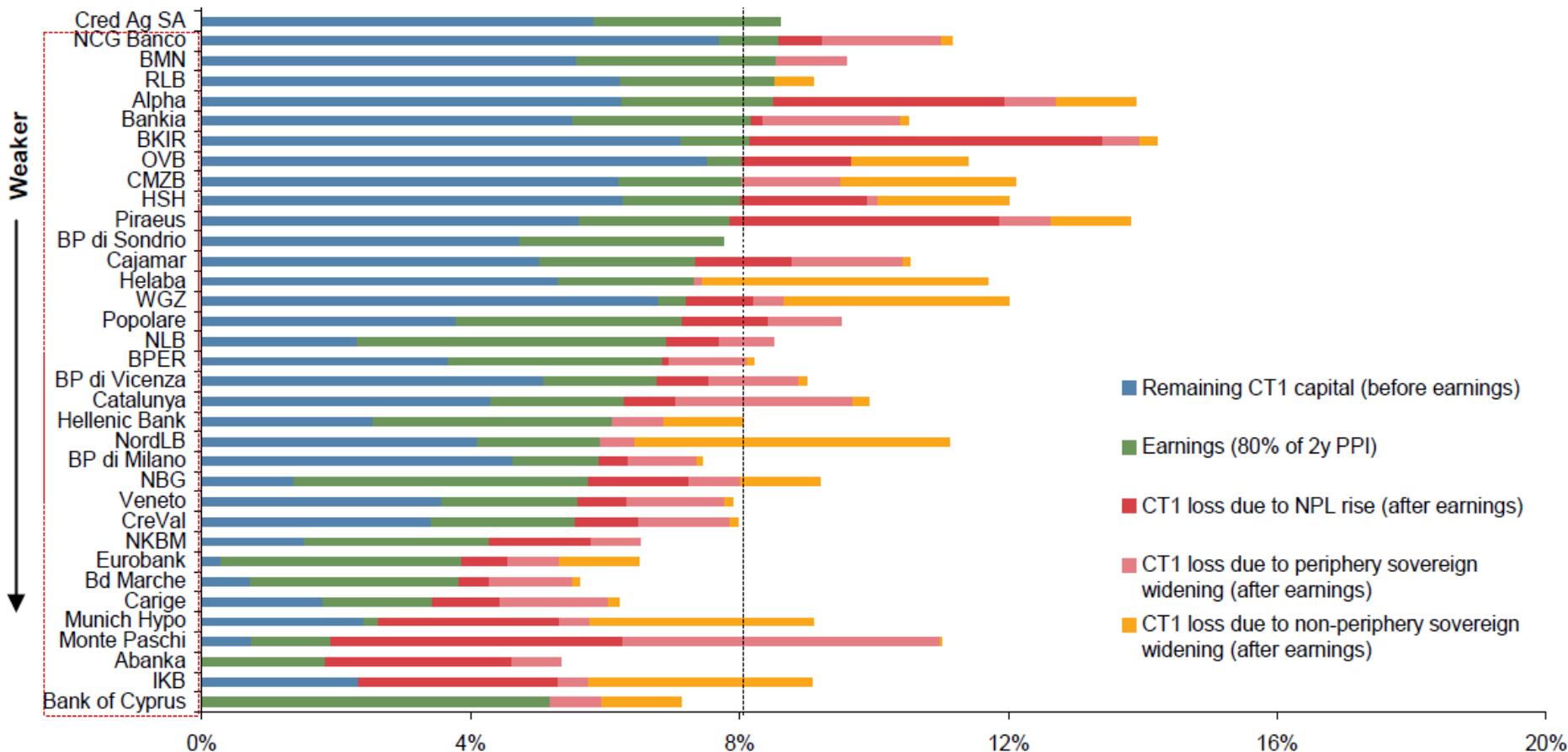
# Eurozone – Steady improvement

**Bank stress tests: Mid-tier Italian, Spanish and Slovenian banks are vulnerable to rising NPLs and sovereign yields**

Stressed Basel 2 CT1 ratio, assuming 30% rise in NPLs, 50% coverage ratio and 100bp widening of sovereign bond yields over 2 years



# Eurozone – Steady improvement



Source: RBS Credit Strategy, Bloomberg, EBA. If sovereign holdings data is unavailable we use the national average, or the average of all banks if no national data is available. Average for Italy: 8.9% of assets in periphery sovereigns with 7.4y maturity. Spain: 7.3% and 7.2y. Slovenia: 9.4% and 6y. 2y PPI is 80% of average pre-provision income in 2011-12, as % of RWAs; We use the most recent filings available to conduct our stress tests. We have not taken into account measures taken by banks to improve capital ratios post-filing. The capital ratios are measured against each bank's own reporting standards, typically Basel 2, 2.5 or the German Solvency standard for the Landesbanks. Slovenska and Tatra appear high as we are using T1 capital because CT1 is not available

## Risks - What could de-rail the Global Recovery?

- Japan – Disorderly bank and bond market adjustment.
- Eurozone - German Constitutional Court veto of OMT.
- U.S. – February default.
- Sudden pick-up in inflation. Synchronised global growth spurs inflation pick-up while central banks still in insurance mode. Markets conclude excess capacity less ample and central banks seen as behind the curve.
- Tail Risk Scenarios – Financial ‘plumbing’ fails; China Lehman moment; geopolitical event triggers oil price spike; extreme weather events; SSA support withdrawal.

# INVESTMENT CLIMATE

# A new landscape

- More than half a decade of rolling financial and economic crises have left large parts of the investment profession confused about **risk** and **uncertainty**.
- Investors who were already challenged by the changing nature of investment risks have often been unprepared to deal with these unprecedented conditions.

# The way forward

1. Dynamic diversification
2. Active management
3. Risk budget control
4. Focus on liquidity



# Dynamic diversification

The three crucial axes of diversification are now:

1. Assets and factors
2. Strategy horizons
3. Portfolio manager profile

# Active management

- Beta will no longer be good enough
  - Be more selective in the future
  
- Look at relative value trades
  - Lower correlation to the market, more diversification
  
- Currencies
  - The best way to play macro themes in a liquid way
  
- Volatility
  - A great way to hedge the portfolio
  - But also a source of alpha

# Active management

- Watershed moment for active management
  - Need to prove its usefulness
  - Need to justify costs compared to passive management
  - Benchmark hugging no longer acceptable
  
- What is the best that passive fixed income can offer over the next 3 years?
  - What would need to happen to make that so?

# Risk budget control

**Risk** applies to situations where we do not know the outcome of a given situation, but can accurately measure the odds

Quoted from “Explained: Knightian Uncertainty” by Peter Dizikes, MIT News Office. June 2010

**Uncertainty**, applies to situations where we cannot know all the information we need in order to set accurate odds in the first place

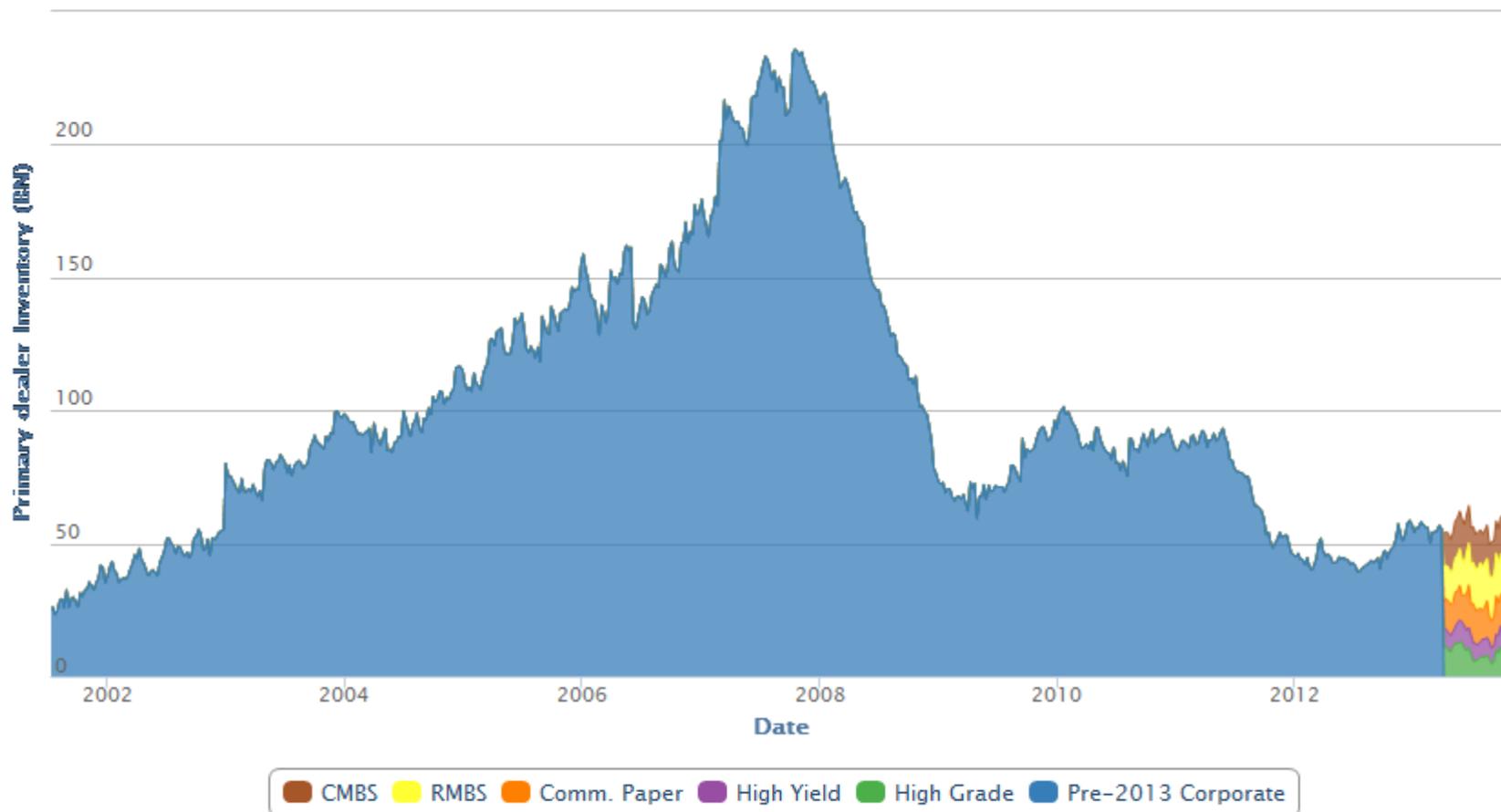
# Risk budget control

- Chasing yield gives a false sense of security
  - Normally steady positive returns
  - Then a large ‘bang’ when everyone tries to exit at the same time
  
- When not compensated for risk – why take more?
  - The question should be – how do you take less risk?
  
- Benchmarks
  - Making you more by losing you less!
  - Absolute return is the future

# Focus on liquidity

Primary Dealer Corporate Bond Inventory  
2001-Present

From Jul 11, 2001 To Oct 30, 2013

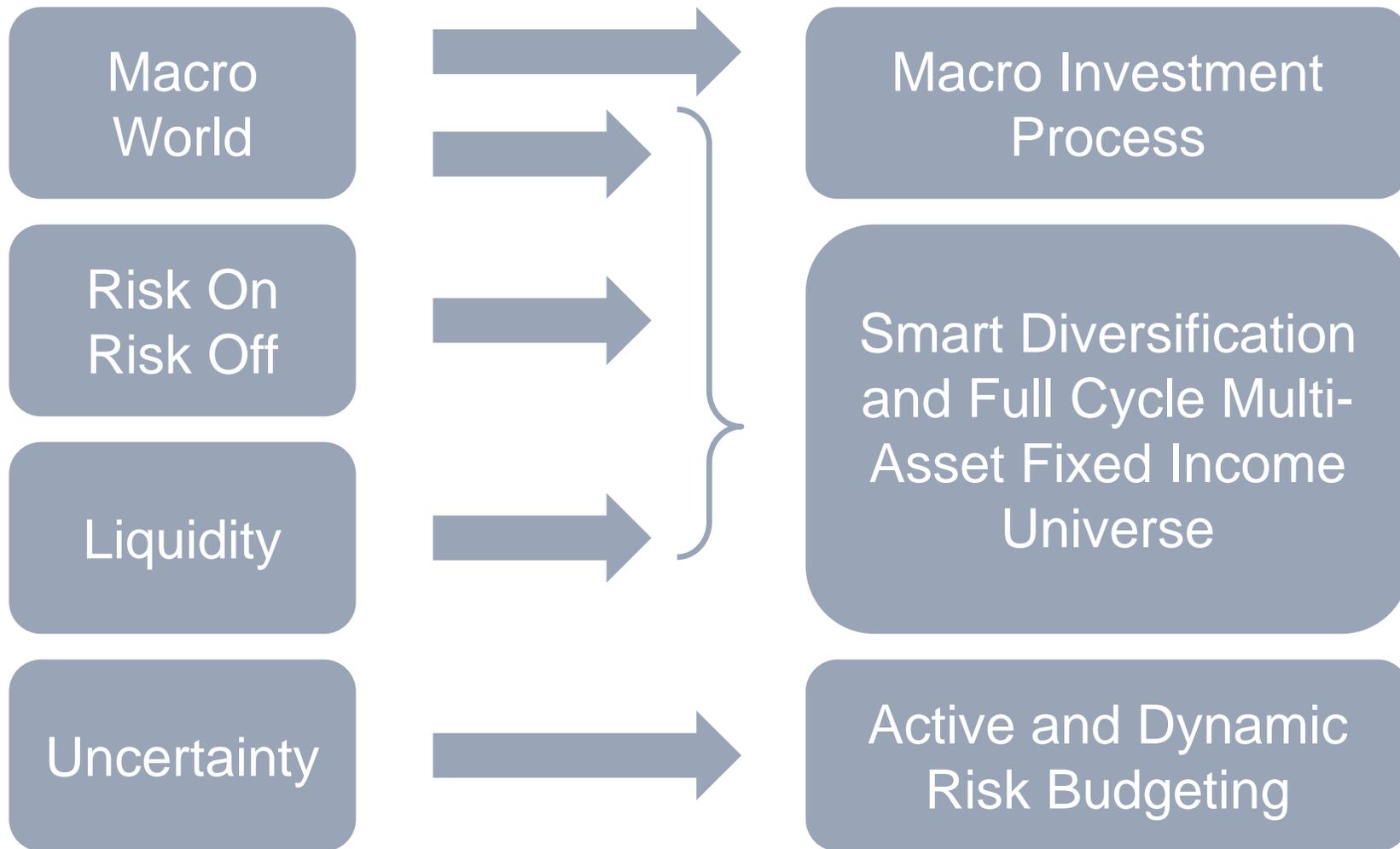


# Focus on liquidity

- Liquidity traps
  - Large flows into esoteric asset classes
  - One step forward, one step forward..... five back



# The solution



**QUESTIONS?**

# Biographies

## **Chris Morris**

Chris Morris spent more than 25 years in the public sector, including 8 years in the UK civil service and 17 years at the International Monetary Fund (during the last 7 of which he working inside the Bank of England). He is very familiar with how policy is formed and implemented and was one of the main authors of the IMF's Global Financial Stability Report.

Since joining Amundi three years ago, he has managed global fixed income portfolios, mainly for pension funds and insurers.

Chris graduated from the London School of Economics and has a master's degree in economics from George Washington University in Washington D.C. He is a qualified accountant.

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## **Merrick Styles**

Merrick Styles joined Amundi London Branch in October 2005 as a quantitative portfolio manager with particular expertise in multi-asset investing. He has previously managed all the Amundi London currency portfolios, unfunded overlays and some global macro mandates.

Until January 2012 he was Head of Absolute Return, partially transferring to the UK subsidiary to co-head its institutional insurance business.

Merrick holds a BEng in Mechanical Engineering (University of Southampton), an Engineering Doctorate in Automotive Engineering (Cranfield University) and a MSc in Investment Management (CASS Business School).

Merrick has been named in the Financial News '40 under 40 Rising Stars of Asset Management' in 2011 and 2013.

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