Confidence must be earned

Amundi ASSET MANAGEMENT

# Monthly Market Review

Our investment perspectives for the month

July 2018


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## A zero-sum game?

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**Just as the Football World Cup continues to surprise - with many of the favourites eliminated, including Germany, Argentina, Portugal and Spain - so too do financial market performances at the end of the first half of the year. This reflects growing economic tensions, rising oil prices, divergent monetary policies and the surging dollar.**

The great surprise of the year so far- the stronger US dollar -is key because it impacts on market liquidity. There are several reasons for this rise. Firstly, the divergence between the Fed's monetary policy and that of other central banks, with the Fed continuing its monetary policy normalisation process. It has already raised its key rates 7 times – including by 25 basis points in June – and is planning a further two rises this year, because growth is strong and inflation is climbing in the United States. Secondly, in Europe, the ECB announced that it would stop buying bonds at the end of the year and would not start raising its base rates until summer 2019. Against this backdrop of divergent monetary policies, the Swiss National Bank and the Bank of Japan are maintaining their accommodative monetary policies. Moreover, the Fed's balance sheet is shrinking, at a time when Donald Trump's fiscal recovery plan is pushing up deficits and consequently the financing requirement. Lastly, the heightened economic tensions between China and the United States could impact on global trade and hence the demand for dollars.

This scenario of a surging dollar and raised economic tensions has weighed down markets, particularly emerging assets and commodities. The former have been under pressure, especially the currencies of indebted countries that are highly dependent on dollar financing, such as Turkey, India, Indonesia, South Africa and Brazil. Data published by the Bank for International Settlements (BIS) confirms that international dollar credit has grown too rapidly in recent years, with emerging markets amongst the biggest borrowers.

Although protectionist threats are difficult to quantify, they could end up impacting on corporate confidence and growth prospects. Furthermore, many companies are in the process of rethinking their strategy, including Harley-Davidson, which has just announced that it is moving its production outside the United States to avoid European tariffs. Other countries such as Australia could well take advantage of the tensions between the United States and China to strengthen their bilateral relations.

The zero-sum game referred to in game theory is exemplified in football by the dread ordeal of shooting at goal: the shooter's objective is to maximise his chance of scoring while the goalkeeper's objective is to minimise it. However, the economy is not necessarily a zero-sum game and the final result from a trade strategy of non-cooperation will depend on the reactions of opponents, with economic war possibly generating loss of value for all players involved. Economically speaking, protectionism is a risky game, in which there is not always a winner.

The American President has just announced that he will not be signing a new NAFTA agreement with Canada and Mexico before the mid-term elections. The end of the game could be in sight for Donald Trump: economic nationalism may have boosted his popularity, but announcements like Harley- Davidson's, fly in the face of the American President's initial objective of creating jobs in the United States. China has not yet said its last word and it is by no means certain that this trade war will play out in the United States' favour. Ultimately, protectionism is more than likely to be a "lose-lose" game...

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# Macroeconomy & Markets

**This month, the US unilaterally imposed tariffs on goods from the EU, Canada, Mexico and China. The latter announced reprisals, raising fears of an escalation.**

- Following a weaker growth phase at the beginning of the year, **United States** indicators point to annualised GDP growth in the second quarter of 3% and an outlook which remains favourable.
- The economic figures for the **Eurozone** remained mixed in June: showing no clear signs of a strong rebound from a disappointing first quarter but in line with growth of around 2% per year.
- Start of June, a new **Italian** government was formed, bringing together the Northern League and the 5 Star Movement, whose economic programme had greatly worried markets in May. However, the government has instead tried to reassure markets, in particular affirming its willingness to respect European budgetary rules, at least in the short term.
- The European Council, end of June, was an opportunity: to define a common strategy on immigration, to announce a strengthening of the European Stability Mechanism, to confirm **Greece**'s eminent exit from its bailout plan and to take stock of the Brexit negotiations.
- Short-term indicators published in May confirm a slowdown in the **Chinese** economy. The authorities are trying their best to manage the situation and have eased their monetary policy slightly, which should provide a breath of fresh air, especially for SMEs.
- In **Turkey**, comments on the independence of monetary policy made by President Erdogan prior his re-election, created a wave of panic causing the Central Bank to have to massively tighten its monetary policy but also to simplify its process to reassure the markets.

| | 09/07/2018 | Over the month | Since 30/12/2017 |
|---|---|---|---|
| **Equity Markets** | | | |
| CAC 40 | 5376 | -1.4% | 1.2% |
| S&P 500 | 2760 | -0.7% | 3.2% |
| EuroStoxx 50 | 3448 | 0.0% | -1.6% |
| MIB | 21926 | 2.7% | 0.3% |
| DAX 30 | 12496 | -2.1% | -3.3% |
| Nikkei 225* | 22052 | -2.8% | -3.1% |
| MSCI Emerging Markets | 1060 | -6.6% | -8.5% |
| **Commodities - Volatility** | | | |
| Crude Oil (Brent) | 77.1 | 0.9% | 15.3% |
| Gold ($/ounce) | 1255 | -3.4% | -3.7% |
| VIX | 13.4 | 1.2 | 2.3 |
| **FX Markets*** | | | |
| EUR/USD | 1.175 | -0.2% | -2.1% |
| USD/JPY | 110.9 | 1.2% | -1.6% |
| EUR/GBP | 0.89 | 1.0% | -0.2% |
| EUR/CHF | 1.17 | 0.5% | -0.4% |
| **Money Rates & Government Bond Yields** | | | |
| EONIA | -0.362 | - | -2 bp |
| Euribor 3M | -0.321 | - | +1 bp |
| Libor USD 3M | 2.33 | +1 bp | +64 bp |
| 2 years Yield (Germany)* | -0.65 | - | -2 bp |
| 10 years Yield (Germany)* | 0.30 | -15 bp | -13 bp |
| 2 years Yield (US)* | 2.56 | +6 bp | +68 bp |
| 10 years Yield (US)* | 2.86 | -9 bp | +45 bp |

* For European and US equity markets and MSCI indices: the values are the closing prices of the day before. For Asian equity indices: closing price of the indicated date. For FX rates, bond yields, gold: values of the indicated date, around 9am (Paris time). Sources: Bloomberg, Amundi Strategy.

## Equity markets

Equity markets fell in June (-0.7% for MSCI ACWI in $). While concerns surrounding Korea and Italy have dissipated, the arm wrestling between the United States and the rest of the world has continued to occupy the forefront with mounting uncertainties about growth. In this context, while the US may seem the winner of this round (+0.5% for the S&P 500), other regions were in more difficulty. The MSCI Europe and Japan fell by -0.5% and -0.7% respectively in local currencies and by -0.9% and -2.6% in US dollars. In Europe, Italy (-0.9%), Portugal (+0.4%) and Spain (+2.1%) outperformed France (-1.3%) and Germany (-2.4%) this month, indicating that trade tensions have taken precedence over peripheral issues. Also confirming this, are the large sectoral declines in Europe for banks (-9.1% in May) and automobile (-9.6% in June). But it was mainly the MSCI Emerging Markets which, for the second month in a row, corrected strongly in June, down -2.9% in local currencies and -4.6% in dollars. This further decline is linked to the gradual tightening of US monetary policy and uncertainties about protectionism. While the correction in April was focussed on Latin America and Central and Eastern Europe, assumed to be more fragile, in June emerging Asia was next to be overhauled (-5.1%).

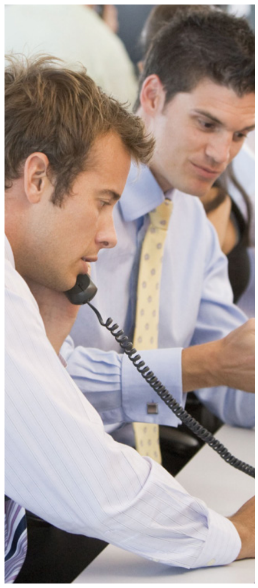
**Past performance and market behaviors do not prejudge future performance and behaviors.**

## Interest rate markets

Fears of escalating tensions continue to weigh on long-term rates in developed countries (German 10-year: 0.31% and US 10-year: 2.9%). On the other hand, the actions of the central banks are feeding the divergences on the short end of the curve. Encouraged by its confidence in US economic prospects, the Fed has adopted a restrictive stance. As expected by markets, the US central bank raised its rates by 25 bp. Instead of three, the Fed is now planning a total of four rate hikes this year. However, the ECB's measures were more accommodating than expected. The ECB announced that QE would end in 2018, while announcing that the first rate increase would not take place before the summer of 2019. The negative credit performance was due to fear among investors of a trade war.

## Foreign exchange markets

Trump's changes of stance over trade tariffs accentuated global uncertainty and the emerging markets, especially currencies, were not left unscathed. Continuing downward pressures on currencies increasingly limited the central banks of these countries in an environment where the oil-importing countries are increasingly affected by price levels



# America and the dollar impact the markets

**The economic data published in June brought no major surprises, showing that the economic recovery is continuing in the major developed countries, albeit at a much faster pace in the United States than in the euro area. The Federal Reserve and, in particular, the ECB made important announcements.**

Political themes continued to retain our attention, whether it was the risk of an upsurge in the trade war or differences among European countries (or within the European governments themselves) over immigration.

## OUR ANALYSIS

### Asset classes

The risk of trade war became more prevalent in June, as markets deemed that the trade war rhetoric was increasingly becoming a reality. In a context of trade tensions, interest rate rises and a rising dollar, we remain cautious on short-term risky assets.

| Negative | | Neutral | | Positive | |
|---|---|---|---|---|---|
| | | Equities | Equities | | |
| | Bonds | Bonds | | | |
| | | | Cash | Cash | |

### Equities

We still prefer equity in this phase of the cycle. US equities are performing well, particularly in the technology, energy and small-cap sectors. There is potential for European equity to catch-up now that political uncertainties linked to the Italian elections have passed. Volatility on emerging markets should continue, given their exposure to world trade.

| Negative | | Neutral | | Positive | |
|---|---|---|---|---|---|
| | | Eurozone | Eurozone | | |
| | | United States | United States | | |
| | | Emerging | Emerging | | |
| | | Japan | Japan | | |
| | | World | World | | |

### Bonds

Risk aversion allowed longterm bonds to remain at relatively low levels, with the US yield curve flattening again. This curve configuration is quite typical towards the end of a cycle.

| Negative | | Neutral | | Positive | |
|---|---|---|---|---|---|
| | Eurozone - Core | Eurozone - Core | | | |
| | Eurozone - Peripherals | Eurozone - Peripherals | | | |
| | United States | United States | | | |
| | | | Euro Inflation | Euro Inflation | |
| | | | US Inflation | US Inflation | |

### Currencies vs EUR

We maintain a positive view on the dollar, in a context of sharply divergent monetary policies between the Fed and other major central banks.

| Negative | | Neutral | | Positive | |
|---|---|---|---|---|---|
| | | | USD | USD | |

### Spreads

In a context of rising interest rates and a rising dollar, emerging bonds were penalized, due to their debt levels and dependence on dollar financing. In this phase of the cycle, markets will become increasingly selective with respect to issuers with significant leverage.

| Negative | | Neutral | | Positive | |
|---|---|---|---|---|---|
| | | Investment Grade EUR | Investment Grade EUR | | |
| | | Investment Grade US | Investment Grade US | | |
| | | | Subordinated Financials | Subordinated Financials | |
| | High Yield EUR | High Yield EUR | | | |
| | High Yield US | High Yield US | | | |
| | | Emerging Local Cur. | Emerging Local Cur. | | |
| | | Emerging Hard Cur. | Emerging Hard Cur. | | |

### Styles, Factors

The gap between growth and value stocks continues to widen with the strong performance of technology stocks. The banking sector remains under pressure: this is explained by the interest rate curve which continues to flatten with the rise in Fed rates and long-term rates which remain low because of investor risk aversion. Finally, the energy sector is doing well, supported by the rise in oil prices.

| Negative | | Neutral | | Positive | |
|---|---|---|---|---|---|
| | | | Value | Value | |
| | | Growth | Growth | | |
| | | | Quality | Quality | |
| | | High Dividend | High Dividend | | |
| | | Small Cap | Small Cap | | |
| | | | Cyclical | Cyclical | |
| | | Defensive | Defensive | | |

### Diversification*

Volatility and gold seem to us particularly appropriate for diversifying portfolios and in the event of significant market stress.

| Negative | | Neutral | | Positive | |
|---|---|---|---|---|---|
| | | | Volatility | Volatility | |
| | | | Gold & related | Gold & related | |

*Diversification does not guarantee a profit or protect against a loss.

## Glossary

### Bank for International Settlements (BIS)

Created in 1930, this body belongs to 60 central banks, representing countries all over the world. Its remit is to support central banks in their pursuit of monetary and financial stability, promote global cooperation in these areas and act as a bank for the central banks.

### Investment Grade

Bonds that are Investment Grade are deemed low risk by the rating agencies. AAA is the highest rating that an issuer can receive.

### LIBOR (or London Interbank Offered Rate)

It is the money market rate observed in London. The LIBOR serves as the reference for many loans.

### MSCI Emerging Markets

Stock index representing about 820 companies listed in the equity markets of 21 emerging countries (South Africa, Brazil, Chile, Colombia, Korea, Egypt, Hungary, Indonesia, Malaysia, Morocco, Mexico, Peru, Philippines, Poland, Czech Republic, Russia, Taiwan, Thailand and Turkey).

### S&P 500 (Standard and Poor's Composite Index of 500 Stocks)

Index representing the 500 largest stocks on the US market.

### Zero-sum game

In Game theory, a two-player zero-sum game (the sum of the potential gains of all the players is zero), there is an average value that represents what the first player can gain at the expense of the second player if they play rationally (i.e. by trying to optimise their gains).

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