September 2019

European perspectives

CEMLA XIII Meeting on International Reserves Management

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Contents

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Latest developments in Europe

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What is new for Europe? Central bank at the forefront

Economy & geopolitics	Financial markets

Economy & geopolitics

- **Growth:** slowdown continued with Germany facing recession, manufacturing activity decelerating
- **Central banks:** Fed cut rates, but markets and Trump expect more. ECB also moving towards an even more dovish stance
- **Trade war:** escalation followed by China retaliation. Conversations should restart, but trade-talk clouds remain
- **Italy:** PM Conte resigned. Italian president gave mandate to form new government
- **Brexit**: the UK Parliament will be suspended ahead of Brexit deadline. No-deal's chances have increased.

Financial markets

- **Volatility is back:** both in equity, bonds and FX, amid greater geopolitical uncertainty
- **Core bonds even lower:** US Treasury down at 1.5 and German Bund yields become negative up to 30Y
- **Italian assets very volatile,** amid political risk
- **FX:** risk of currency war on the rise – **EUR** driven by sudden and strong repricing of expected rate cuts from the ECB. GBP continues to weaken in the face of rising tensions on the Brexit negotiations.
- **Oil:** crude oil prices in trading range, with movements correlated to the trade war dynamics

Source: Amundi, as of 29 August 2019. CBs = Central Banks. ECB: European Central Bank. EM = Emerging Markets.

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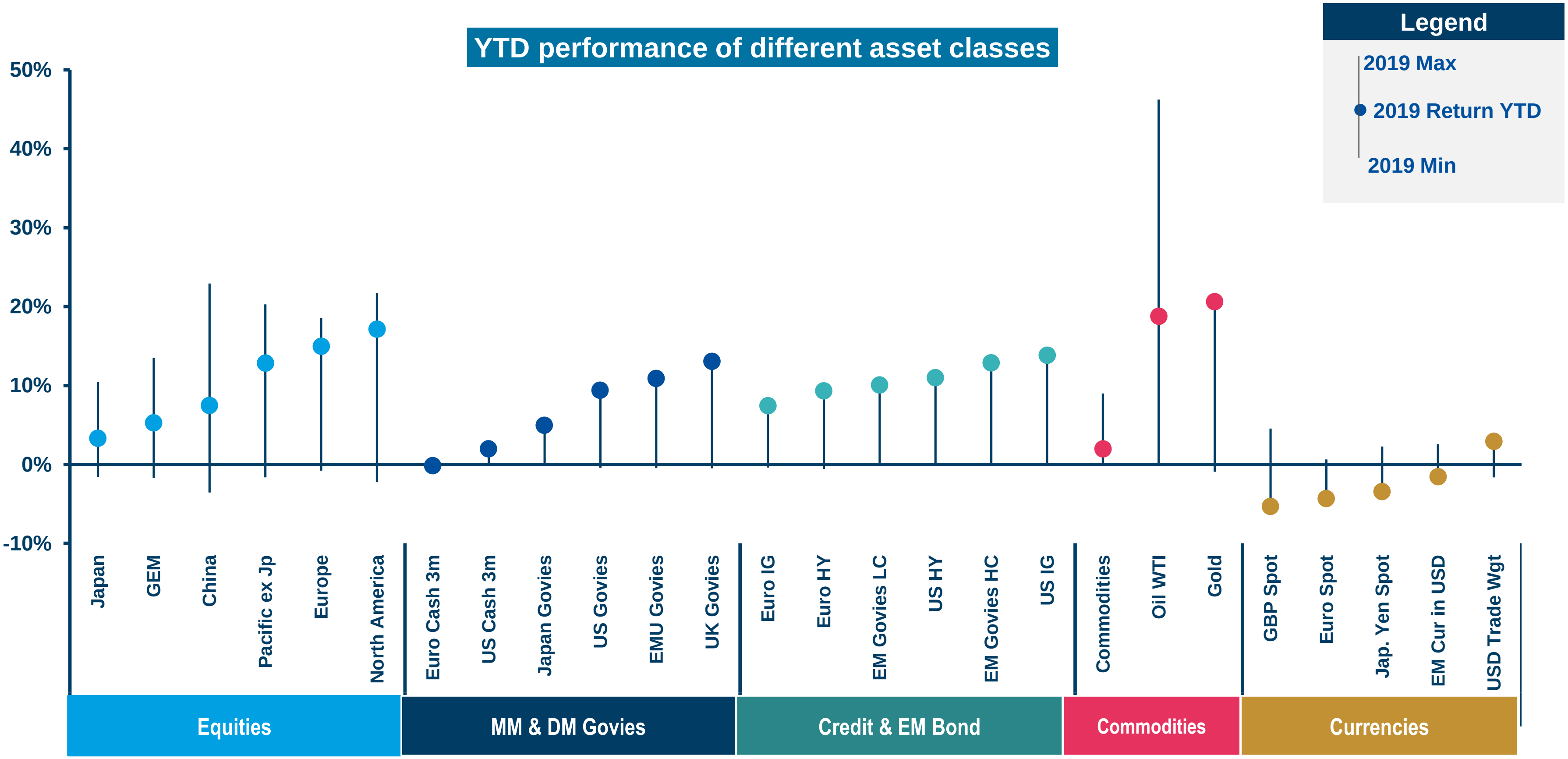
Markets remains resilient year-to-date



Source: Bloomberg, analysis by Amundi on 26 asset classes (and FX). Data as of 3 September 2019. Index providers: Cash, Government bonds and EM Bond indexes are from JPMorgan. Corporate bond indexes are from BofA Merrill Lynch. Equity indexes and EM currency index are from MSCI. Commodities indexes are from Bloomberg Barclays. All indices used to represent asset classes **are in local currency**. **Past performance is no guarantee of future results.**

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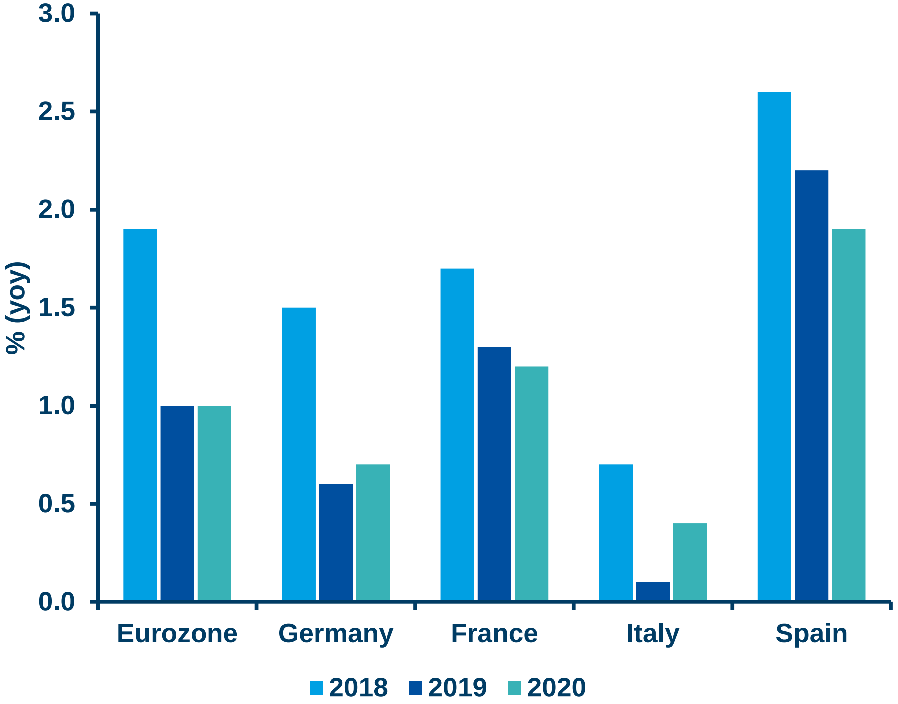
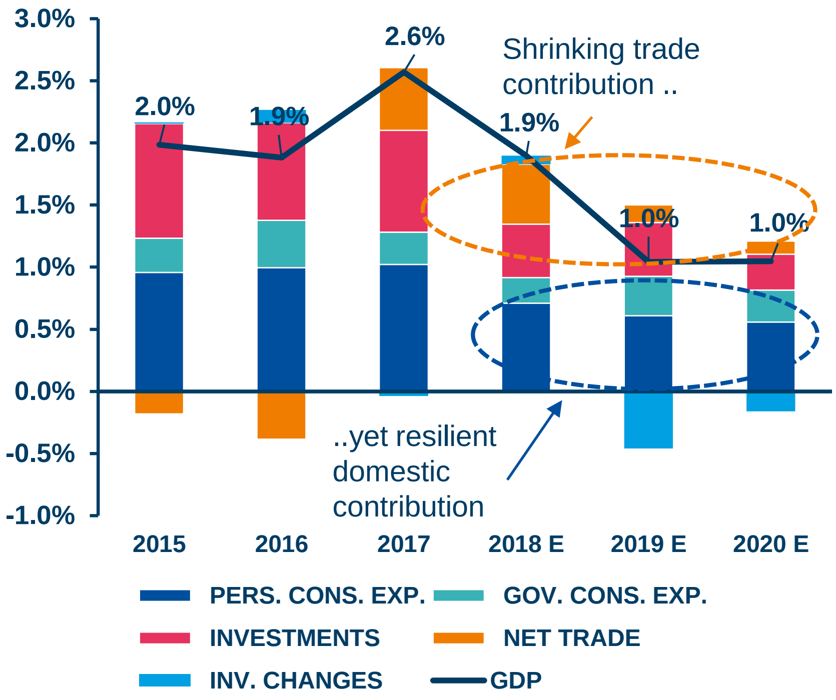
Eurozone: limited upside for growth

Real GDP growth by country



EMU GDP Contributions, annual average



» Growth divergence masks different domestic conditions, trade openness, vulnerabilities. On the **domestic side**, our outlook relies on consumer resilience and deployment of some fiscal support for 2019 On the **external side**, a gradual stabilization of the trade flows at global level.

Source: Amundi Research forecast, Bloomberg. Data as of 30 August 2019.

Source: Amundi, Bloomberg. Data as of 30 August 2019.

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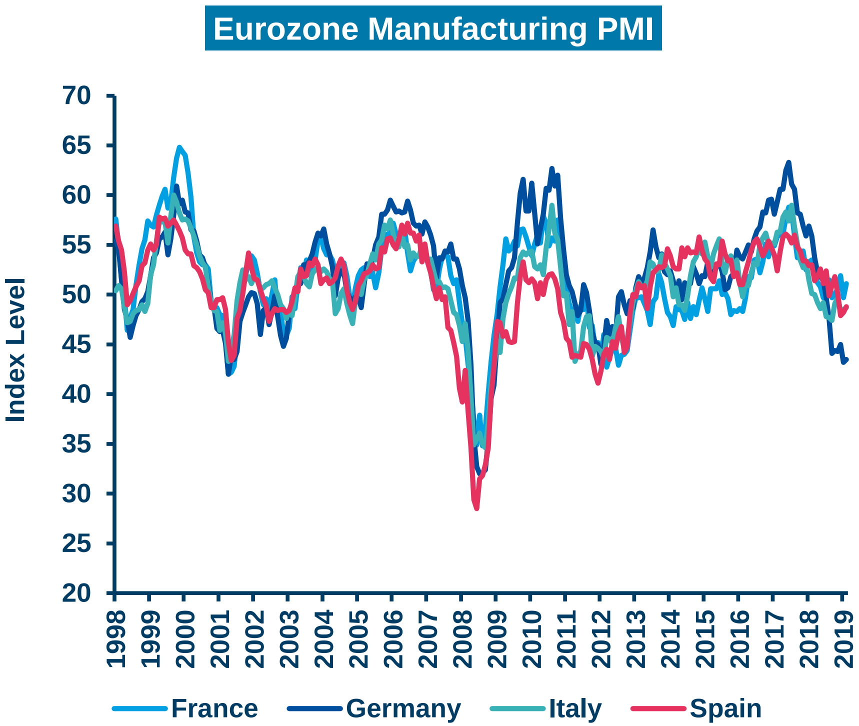
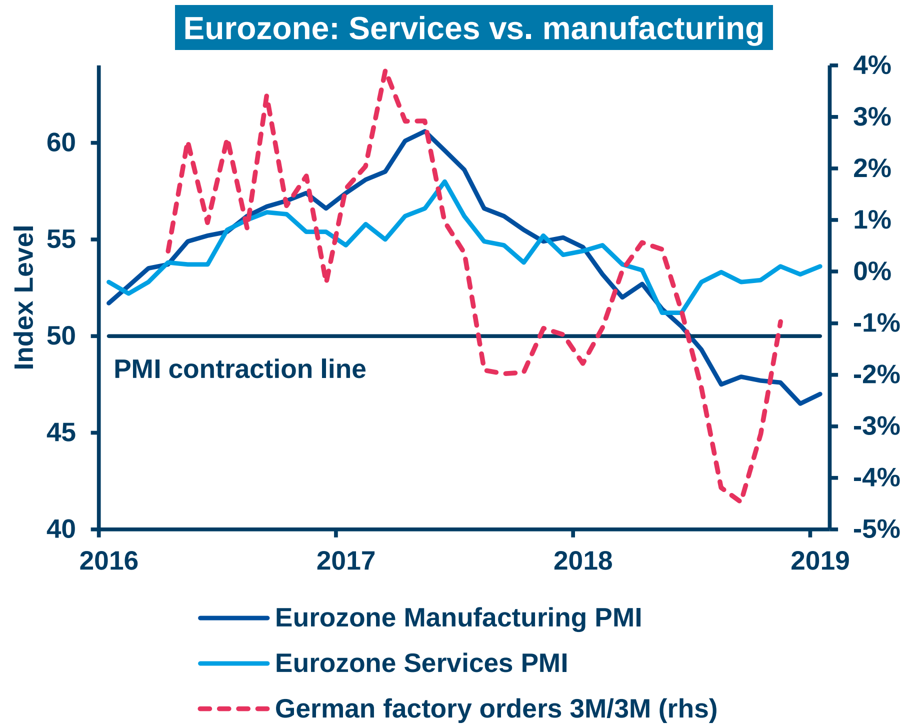
Growth under pressure from protracted weakness in manufacturing





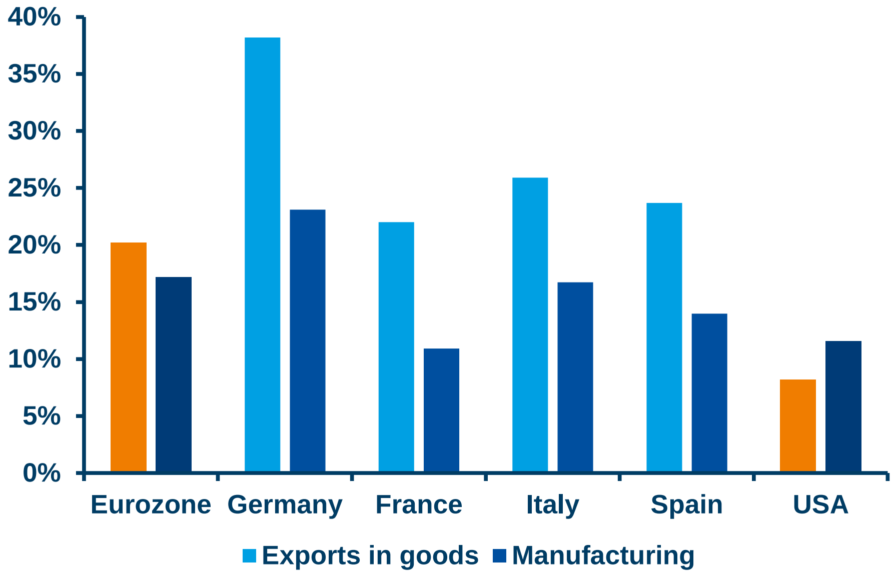
» **Weak growth** Manufacturing-intensive economies take most of the pain. Negative German growth in Q2 trigger recession fears. **Q3 brought little respite**: further deterioration in business confidence indicators; problematic newsflow (new Trump tariff threats, rising hard-Brexit risk, new Italian government crisis,…)

Source: Datastream, Amundi. Data as of 3 September 2019.

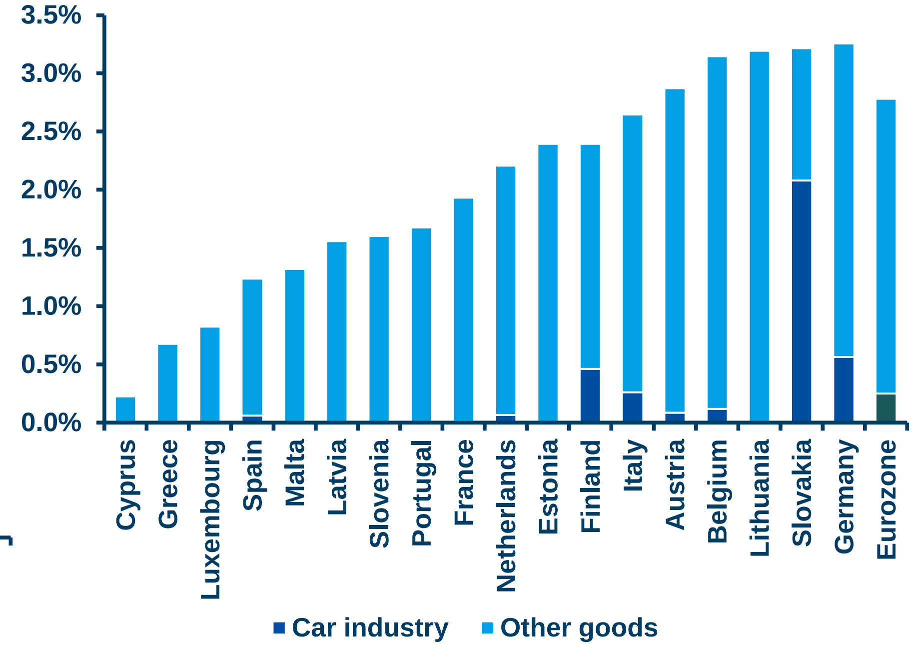
Source: Datastream, Amundi. Data as of 3 September 2019.

… and from unabated trade tensions

Share of exports in goods and manufacturing in each economy



Exports of goods to the US (% of GDP)



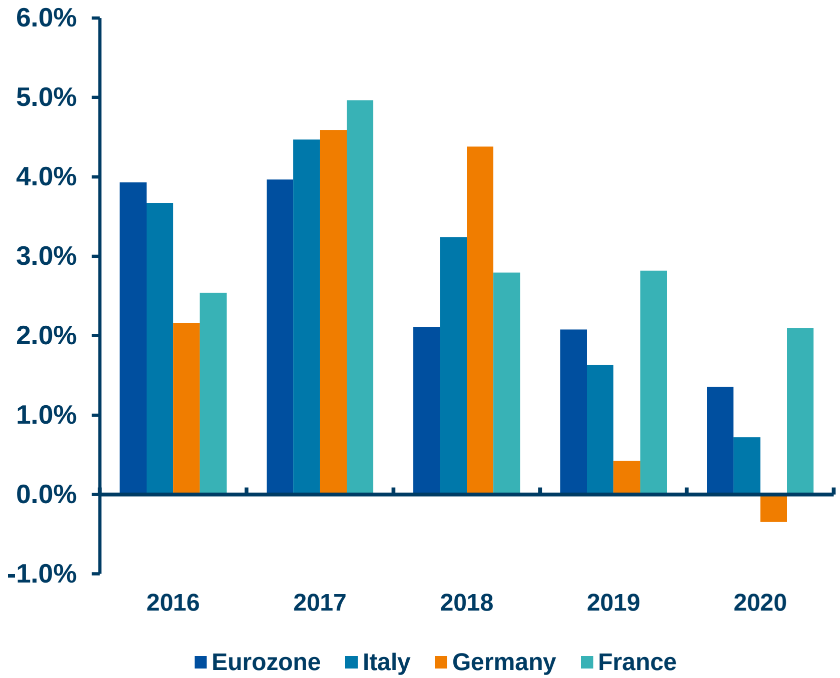
» **The Eurozone is more exposed** to international trade than the US. Exposure varies a lot across countries (Germany and Italy more vulnerable than France and Spain). **A Material Risk:** protectionist measures against Europe (US tariffs on cars) and/or a no-deal Brexit would bring additional damage.

Source: OECD, Amundi Research. As of 3 September 2019.

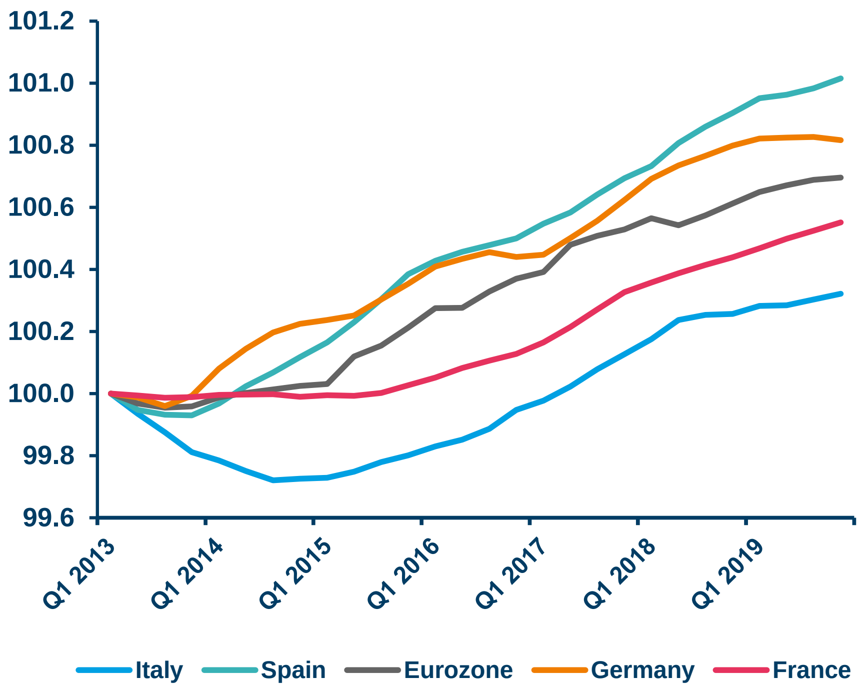
Source: International Trade Center, Amundi Research. As of 3 September 2019.

Fixed Investments lost momentum

Fixed Investments (YoY average growth rate)



Gross Fixed Capital Formation, 2013=100



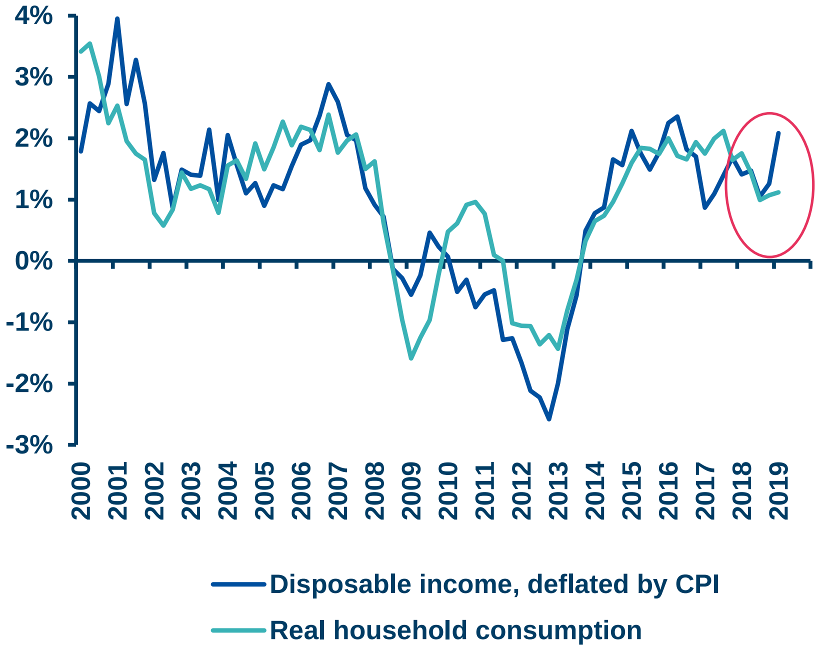
» We expect further weakness in fixed investments for 2019 and 2020 across G4 EA countries, particularly in Italy and Germany. Likewise, the flattening of the gross fixed capital formation is particularly evident for Germany and Italy (the countries more hit by trade uncertainty and manufacturing weakness).

Source: Amundi Research forecast, Bloomberg. Data as of 30 August 2019.

Source: Amundi Research forecast, Bloomberg. Data as of 30 August 2019.

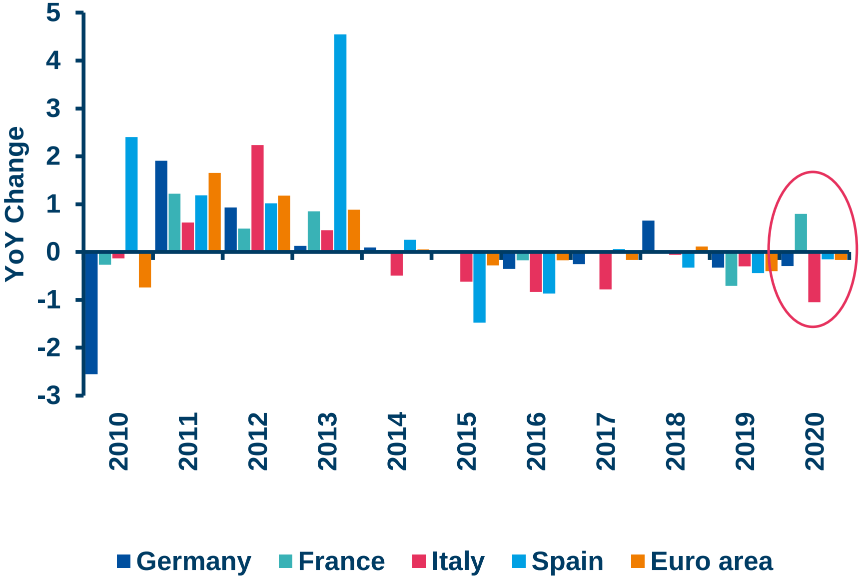
A bright spot: supportive factors for domestic demand

Real disposable income and consumption



Source: Datastream, Amundi. Data as of 3 September 2019.

Fiscal stance adjustment (cyclically-adjusted primary deficit)



Source: DG ECFIN, Amundi Research. Data as of 3 September 2019.

Household real disposable income remains supported by rising employment and wages and subdued inflation (Oil prices lower than in 1 year ago). **Already significant fiscal support** (for different reasons) in the 4 largest countries (approx. 0.5% of GDP), while more could come due to the broad-based weakness in the economic environment.

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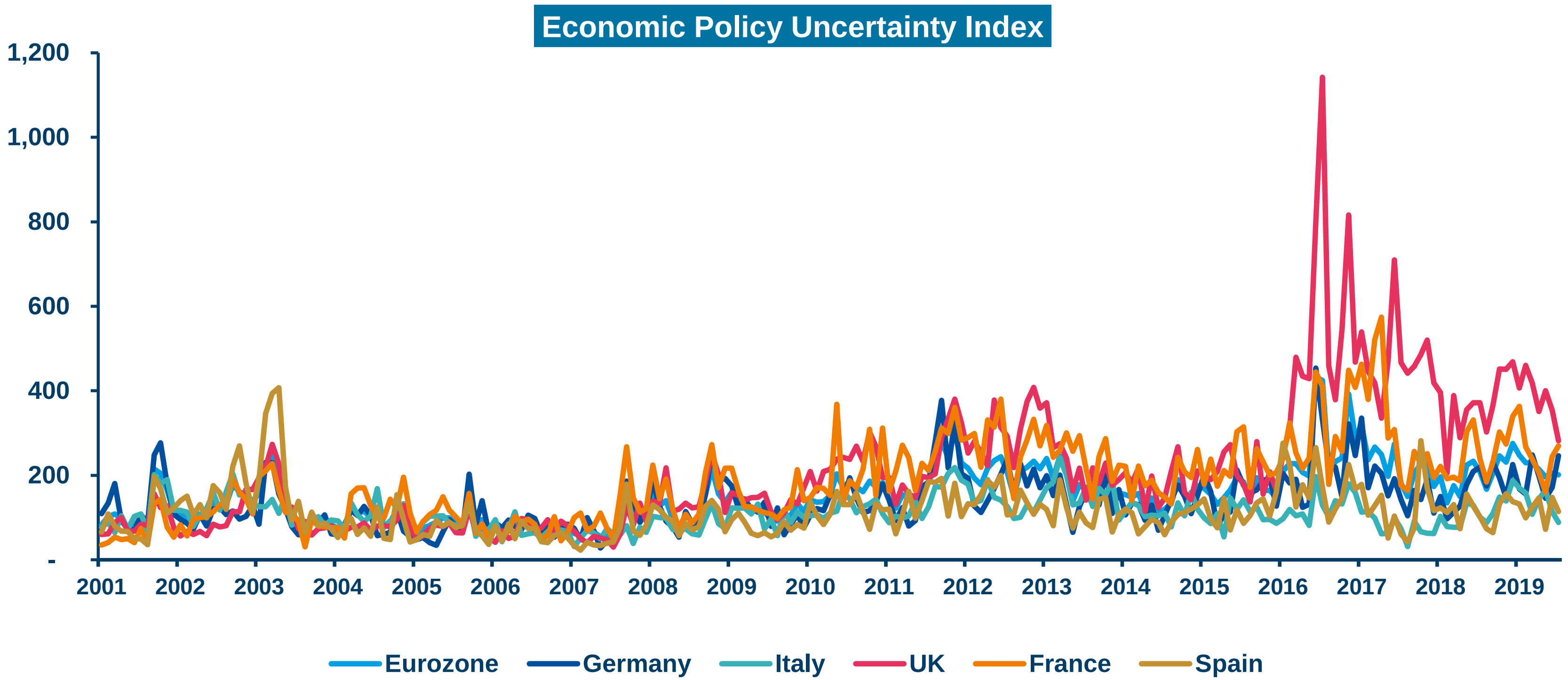
Policy uncertainty set to move higher



» Global policy uncertainty increased overall due to political uncertainty and increased risks. Global trade disputes, tensions in Gulf Area, European fragmentation are some of the geopolitical risks in the spotlight.

Source: http://www.policyuncertainty.com/europe_monthly.html, as of July 2019

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Italy: a very volatile political news flow

Italy – Political and credit ratings timeline

Last day for the **appointment of an Italian European Commissioner**
26 August (some more days given to Italy)

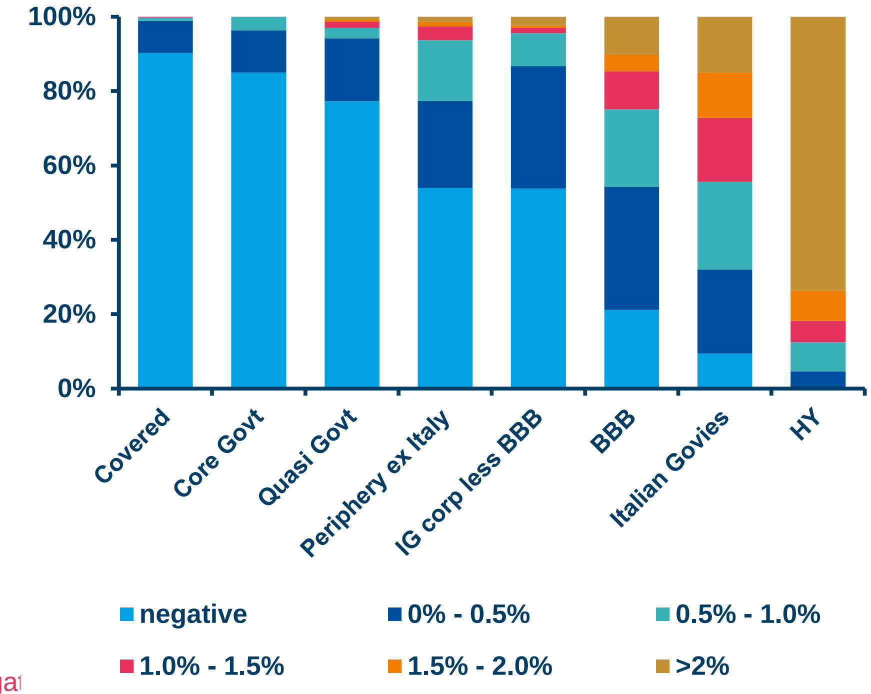
First budget law draft to be submitted to Parliament
Mid September

Start of the review of the budget law for 2020 to be **submitted by 15 October to the EC** and approved by year end
27September

6 September
MOODY'S
Currently
Baa3 - Outlook Stable

25 October
S&P Global Ratings
Currently
BBB - Outlook Negat

Euro-fixed income assets by yield buckets



» Success in coalition talks has been supportive of Italian bonds, previously favoured by a positive technical backdrop (the Italian Treasury has already placed 68% of the yearly scheduled new issuance) as Italy's bond market offers relatively attractive yields in Europe.

Source: Bloomberg and Amundi Research, as of 29 August 2019.

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UK: the economy is gearing up for a no-deal scenario

New PM **B. Johnson** has continued to state his:

- intention to deliver Brexit on 31 October, whatever happens
- belief that the EU may agree to renegotiate in the end (i.e. first and foremost on the Irish backstop) provided the UK threat of a no-deal Brexit is kept credible
- willingness to do everything possible to prevent Parliament from blocking no-deal before 31 October, including going for early elections

- This very hawkish attitude was confirmed on 28 Aug. by his decision to reduce the number of days Parliament would sit before Brexit
- The EU continues to state that the Withdrawal Agreement is not open for renegotiation
- However, on Aug. 21, A. Merkel gave B. Johnson 30 days to propose a solution on the "Irish backstop"

TIMETABLE

Sep 3: UK Parliament reconvenes
Sep 11 (tbc): Parliament is suspended for the Parties' conferences
Sep 14 – Oct 3: Conferences of the 3 major mainstream Parties (Tories, Labour, LibDem)
Oct 14 (tbc): UK Parliament reconvene
Oct 17-18: EU Council meeting
Oct 31: Art. 50 current deadline

BREXIT SCENARIOS AND IMPLICATIONS

Scenario	**Ratified deal before Oct. 31**	**Further extension beyond Oct. 31**	**No-deal Brexit**
Probability	**20%**	**50%**	**30%**
GBP/USD (range)	1.35 – 1.40	1.28 – 1.33	1.10 – 1.20
Stocks	Up – outperform	Flat – in line with other markets, higher volatility	Down in the short term with limited downside; possibly up in the long term
10Yr Gilts	Lower yields from dovish BoE	Yields following global trend; BoE incapable to act	Higher yields as weak currency does not allow BoE to cut rates & possible downgrade
2-10 Curve	Steepening	Following global trend	Steepening
Corporate spread	No impact	Small widening	Widening in € and £; UK consumer & auto worst from FX

Source: Amundi Research. Data as at 26 August 2019.

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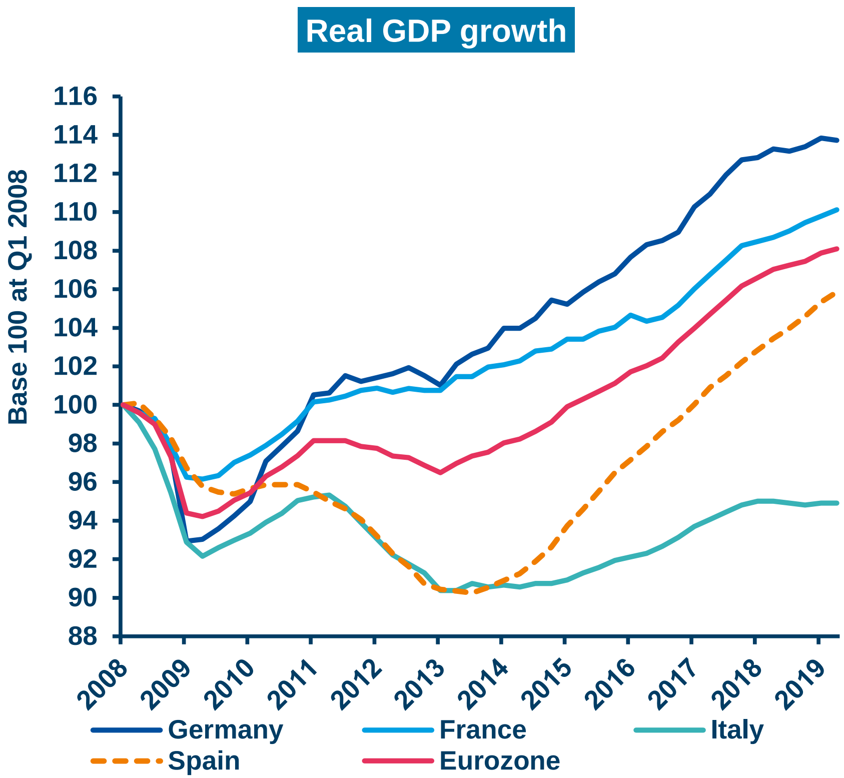
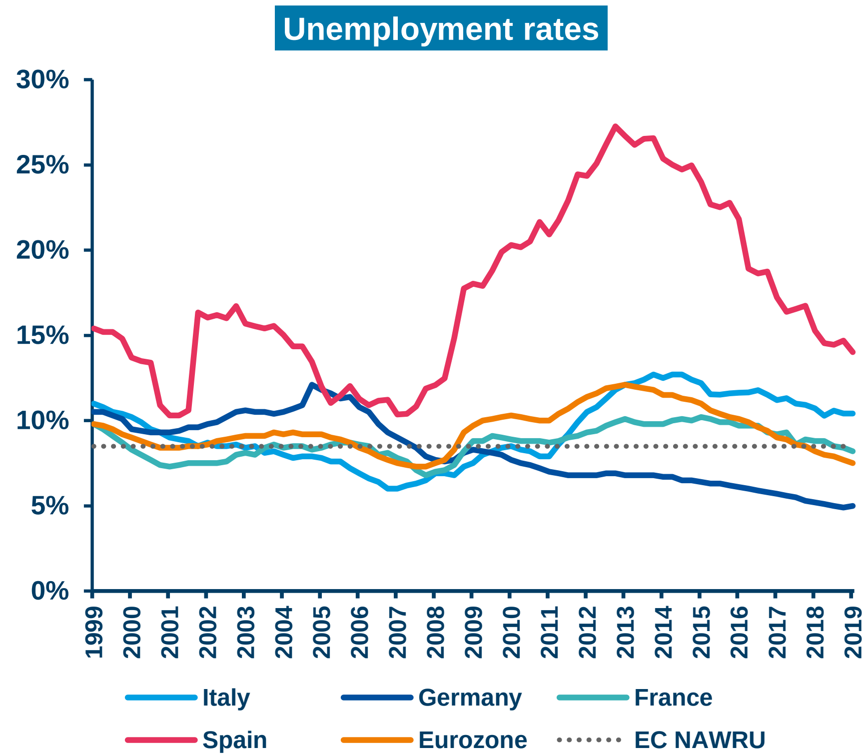
02

European Central Bank under the spotlight

ECB headache #1
Many economies





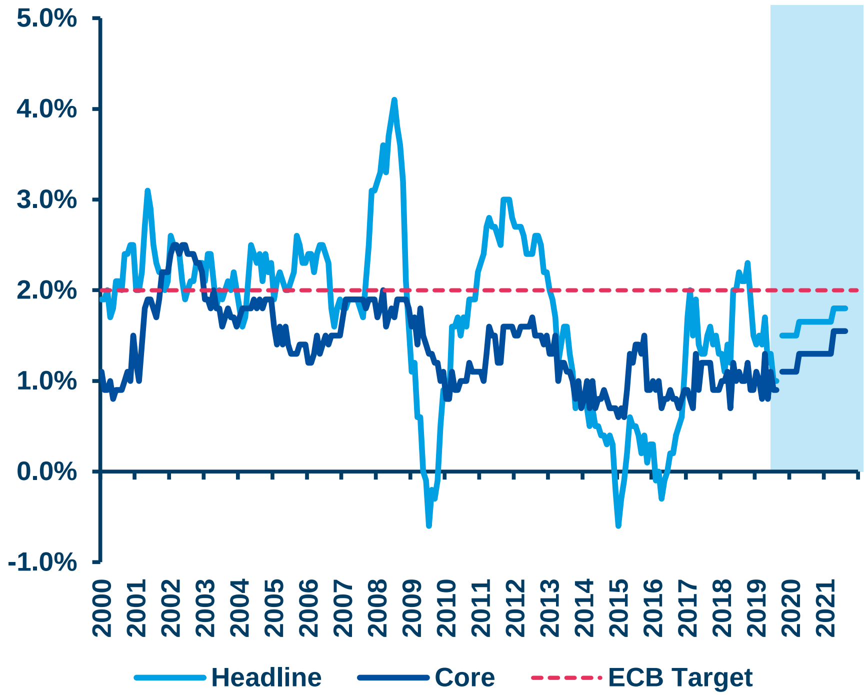
» Eurozone economies are still at different stages of their post-crisis recovery, in terms of growth and labor market.

Source: Bloomberg, Amundi. Data as at 26 August 2019.

Source: Bloomberg, Amundi. Data as at 26 August 2019.

ECB headache #2

Core inflation still unmoved and new lows in LT inflation expectations



» Core inflation retreated to 1.0% in July, still no convincing evidence of an upward trend. **Powerful long lasting disinflationary factors** are at play (probably related to structural changes in the organization of labour, product and services markets). **Long term inflation expectations** raising new de-anchoring fears.

Source: Bloomberg, ECB forecasts, Amundi. As at 3 September 2019.

Source: ECB survey of professional forecasters (SPF), Amundi. As at 3 September 2019.

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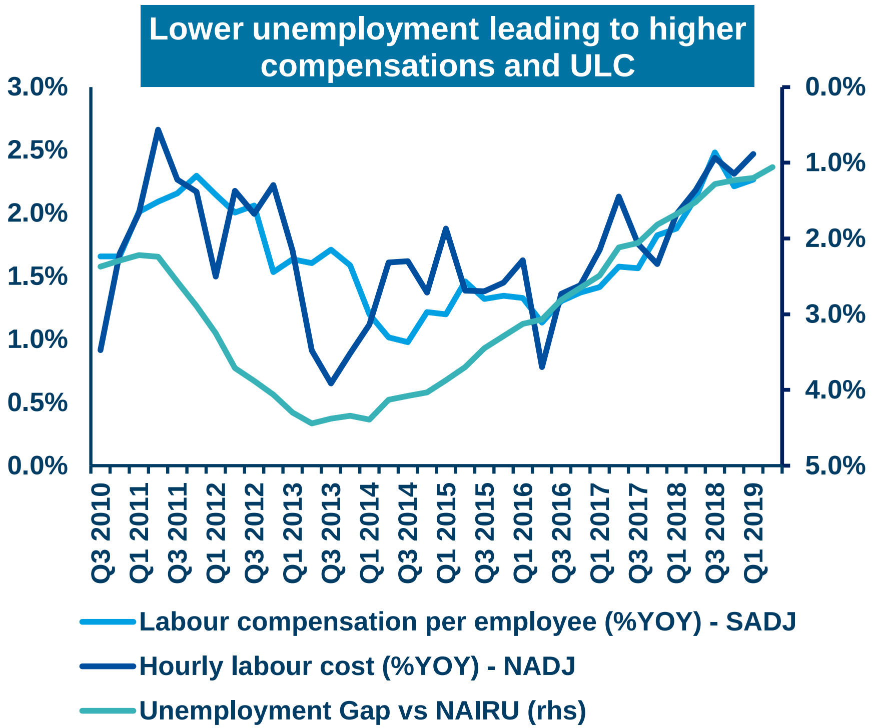
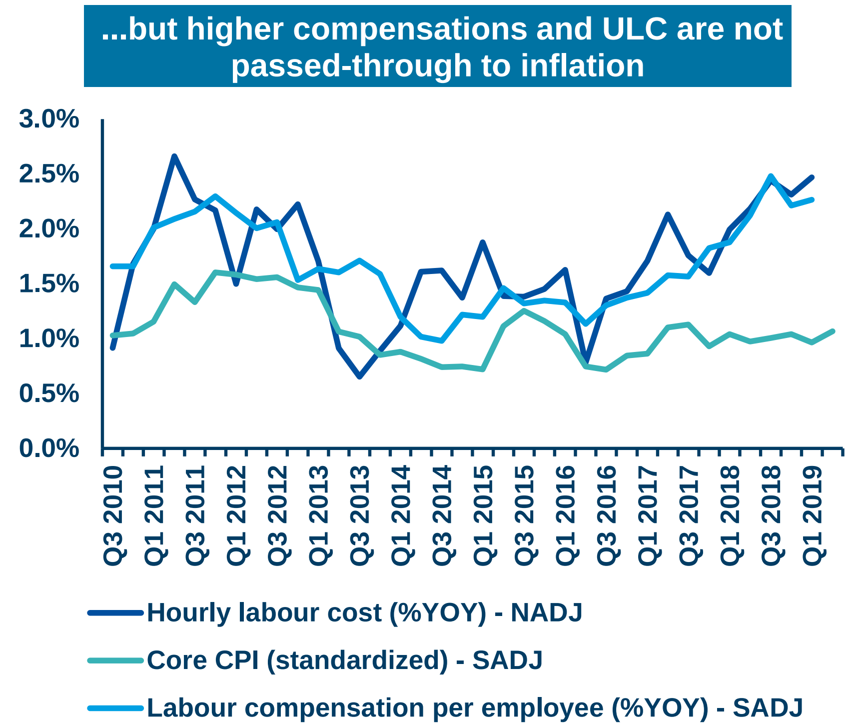
ECB headache #2bis

Transmission mechanism from wages not as usual





» While lower unemployment translates into upside pressure on wages and unit labor costs (ULC) this is not translated into inflationary pressures.

Source: Amundi Research, as of August 2019

Source: Amundi Research, as of August 2019

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ECB QE2

Three major approaches at ECB disposal for QE2

1. A “soft” approach, small-size scale, aimed at using all remaining available space left within QE1 set, without changing major self-imposed limits and without including new asset classes in the programme;
2. A “mixed” approach, potentially mid-size scale, keeping the focus on asset classes targeted in QE1, but combining some of the existing parameters with the revision of some self-imposed limits;
3. A sort of “Bazooka” package, combining a large-scale programme with the introduction of new asset classes (ie, equities or bank bonds) and a significant revision of existing parameters.

All the three approaches above obviously come with pros and cons:

- ❑ the first one would probably meet more consensus among ECB hawkish members and looks easier to agree upon as a way to restart QE, but has the evident cons to show limited effectiveness in keeping easy financial conditions;
- ❑ the third approach on the opposite, is likely to produce a strong easing of financial conditions, but it looks unlikely to meet a large consensus and would probably exhaust most of still available ammunition in the Central Bank’s toolkit, raising also some questions about legal aspects regarding the inclusion of new asset classes;
- ❑ the second approach looks like a better mix than the two extreme scenarios in terms of combined effectiveness & credibility on one side and not too strong hurdles for its delivery.

Source: Amundi Research, as of September 2019

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03

Implications for fixed income and FX

Market implications from different ECB policy packages

What are the likely reactions to the different options at ECB disposal?

1. The soft approach would likely disappoint market expectations, due to its limited headroom, leading to a possible initial sell-off and curve steepening in bond markets, widening periphery spreads and neutral to slightly negative effects on credit (the reopening of CSPP and higher reinvestments in 2020, should anyway offer some support to the asset class)

2. The "Bazooka" package, on the contrary, would likely produce the most supportive effects on risky assets (both credit and equities), on financials and periphery govies, while supporting as well to a lower extent core govies, with a moderate flattening as remaining spaces are limited.

3. The intermediate, mid-size scale approach, which is likelier in our view, is already at least partially discounted by bond markets, but depending also on its design (the combination of monthly size and number of monthly purchases) it could keep the trend towards some moderate flattening in core govies, and would likely support linkers, corporate bonds and periphery govies.

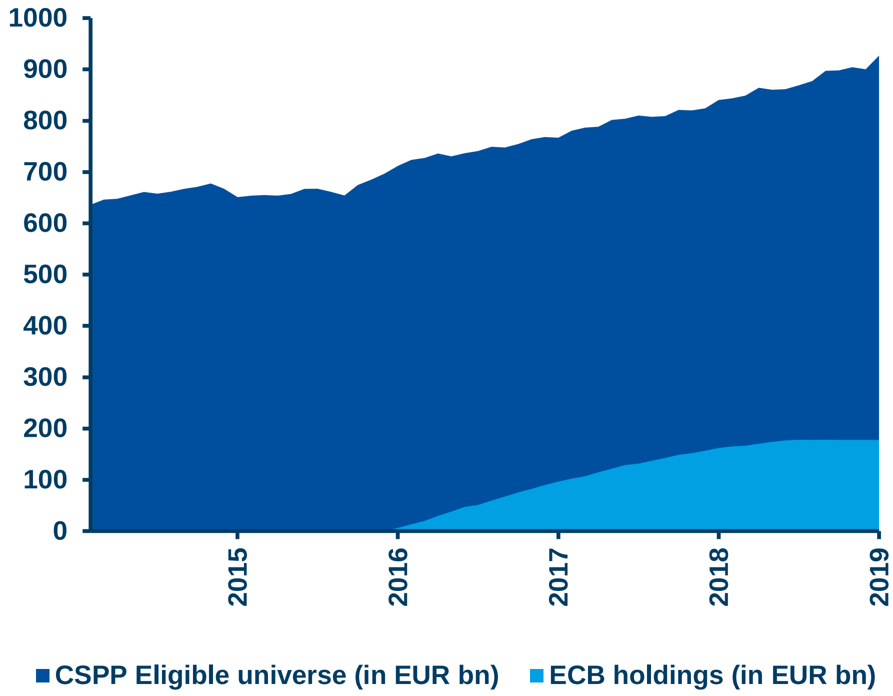
4. The rise in APP reinvestments in 2020, especially in some programmes (PSPP and CSPP) would contribute to make more effective the eventual reopening of net purchases and to support both govies and credit markets.

5. Surprises on the rate cut move would produce their impacts mainly on financials and the currency. A 10bp cut is consensual, while a more aggressive 20 bp cut (from -40 to -60) of the depo rate is likely to negatively impact both credit and equity financials, unless a strong further easing of TLTROs conditions and/or an effective tiering system are not put in place.

Source: Amundi Research, as of September 2019

Reopening of CSPP among the "easiest" ECB options

Plenty of space for the ECB to re-open CSPP



Estimated ECB holdings in % of eligible universe vs limits

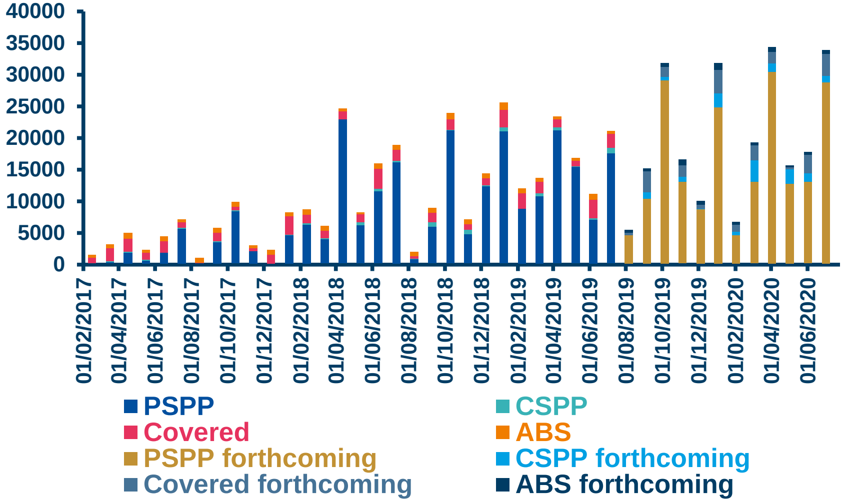
	ECB holdings	ECB issue/r limit
Sovereign / Sov. like bonds*	25%	33%
Supra	39%	50%
Covered Bonds	40%	70%
Corporate Bonds	20%	70%

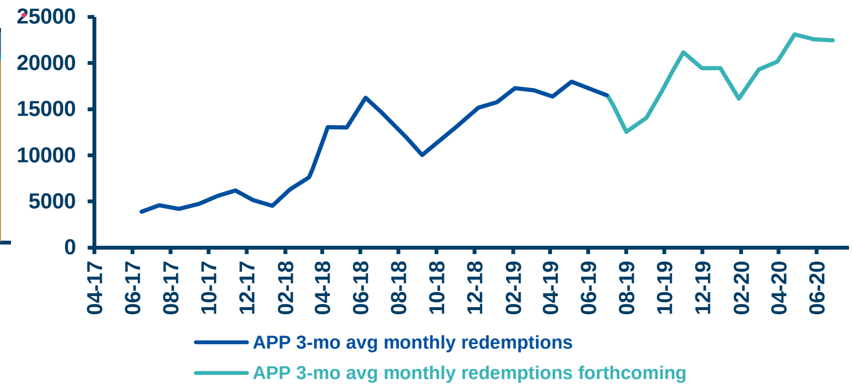
* for Germany and Finland > 30% and close to 33% limit.

» ECB holds €177bn of corporate bonds, close to 20% of the eligible universe, the lowest proportion among ECB QE programmes. Holdings in Supra and Covered bonds are already double the holdings in corporate bonds in % on the correspondent universe. Overall holdings of sovereign bonds are at 25%, but due to the capital key rule and market size of each sovereign debt, holdings in some core countries are already close to the 33% limit.

Source: ECB, Amundi Research, as of August 2019

APP reinvestments to increase their support in 2020…





ECB reinvestments are on the rise in 2020: PSPP forthcoming redemptions published by the ECB point to roughly EUR 190 in the next 11 months, vs EUR 150 of the last 12-months and vs just EUR 86 bn of the same period last year.

3-month monthly averages of APP (the four programmes altogether) redemptions reached EUR 16 bn, to rise to EUR 23 bn by H1 2020 (chart bottom left).

Estimated overall redemptions next year point to an increase of roughly EUR 40 bn vs 2019 (see chart bottom right)

Source: Bloomberg, Amundi Research

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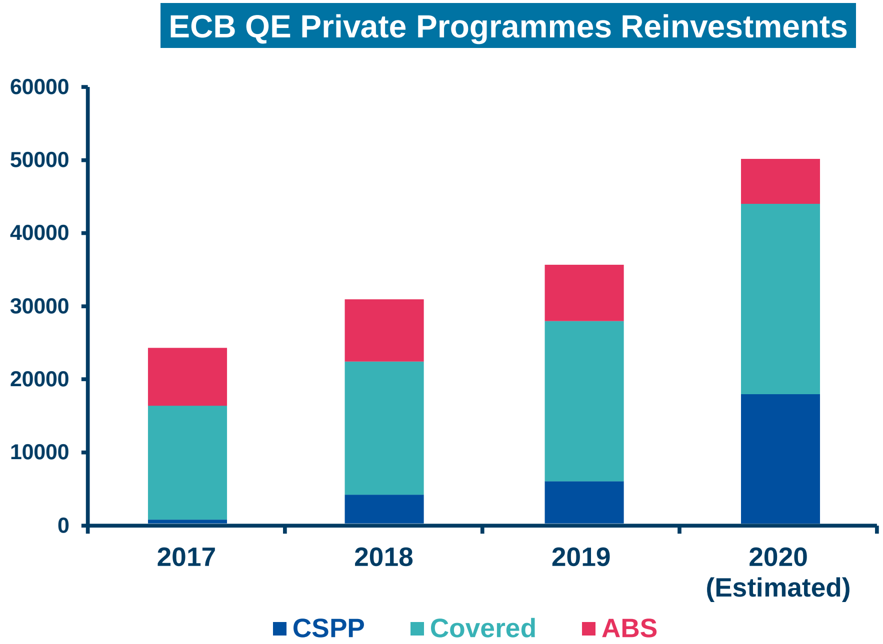
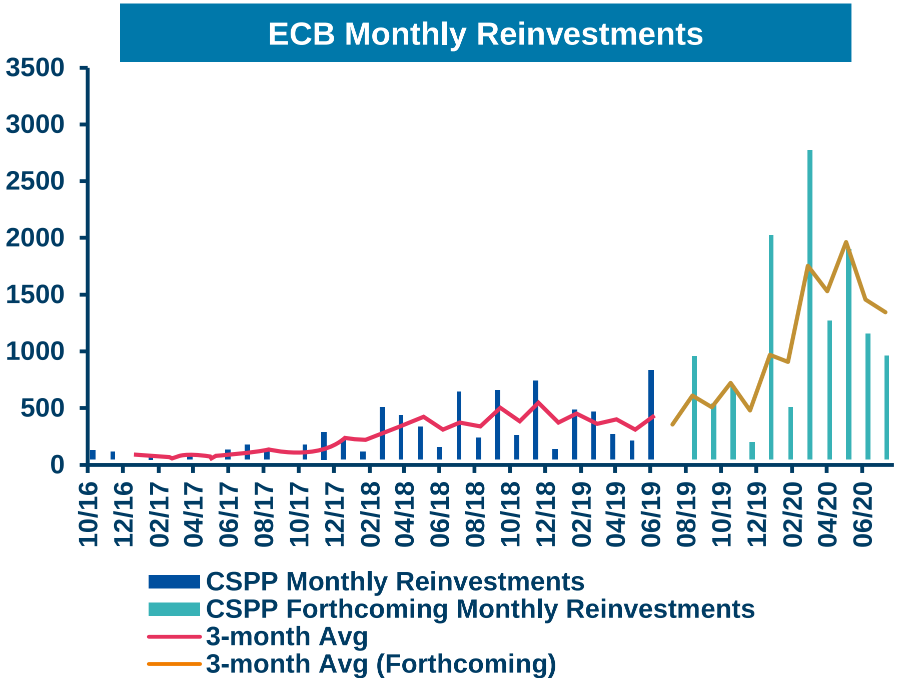
… And corporate reinvestments to rise the most on a relative basis





» According to our expected purchases of reinvestments in ECB QE private programmes in 2020 (vs past volumes), the strongest acceleration in reinvestments will take place in corporate bonds, probably reaching roughly €18bn vs €6bn in 2019 and €4bn in 2018. Monthly reinvestments will rise significantly in 2020, from a €400mn monthly 3-month avg to a 3 times higher volume next year.

Source: Bloomberg, Amundi Research

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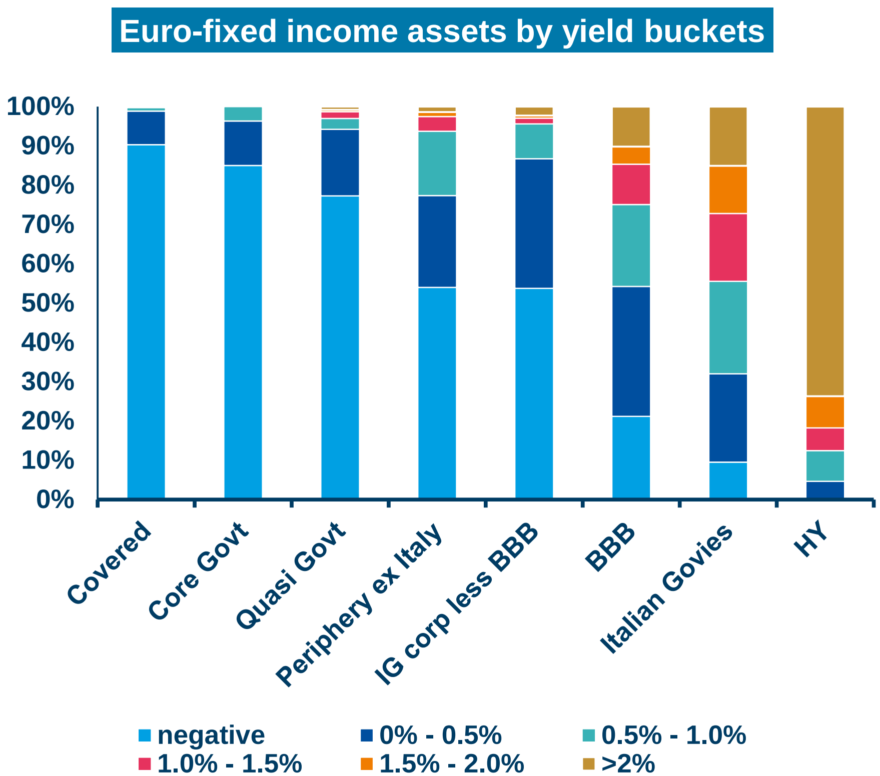
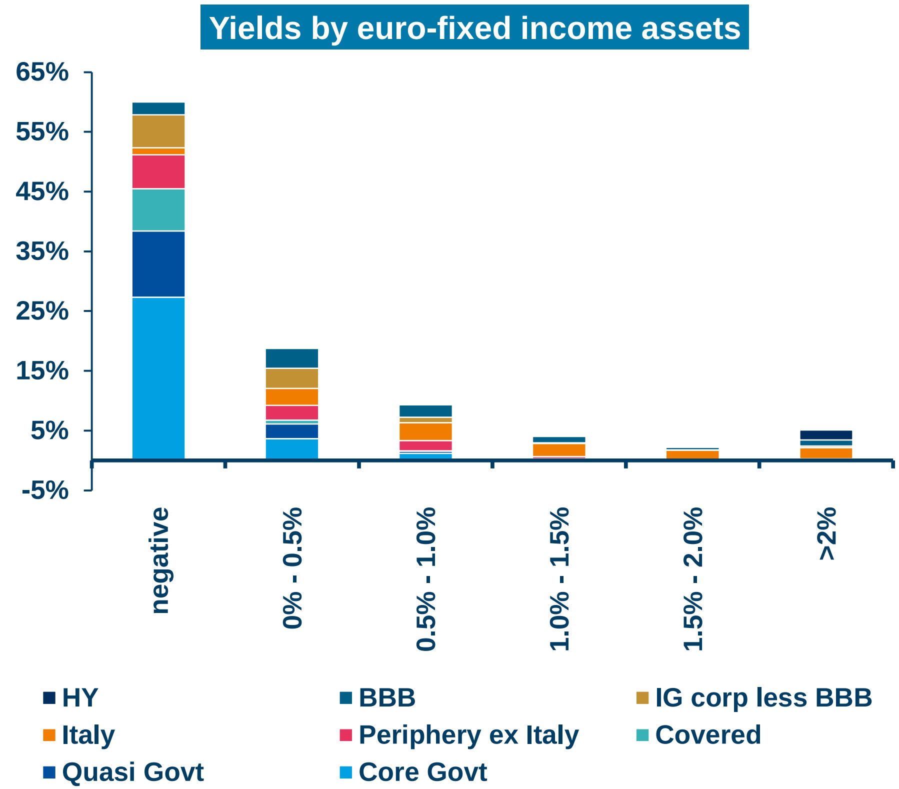
Euro fixed income and the "desert of yield"





» BBBs, Italy and HY debt are the only segments still offering yield above 1.5%. Almost all debt of core govies, quasi govies and covered bonds debt is in negative or flat territory. Recently, also the weight of periphery ex Italy and non-BBB corp. in negative territory increased to significant levels, both to 54%.

Source: Bloomberg, Amundi Research, as of August 30, 2019.

Source: Bloomberg, Amundi Research, as of August 30, 2019.

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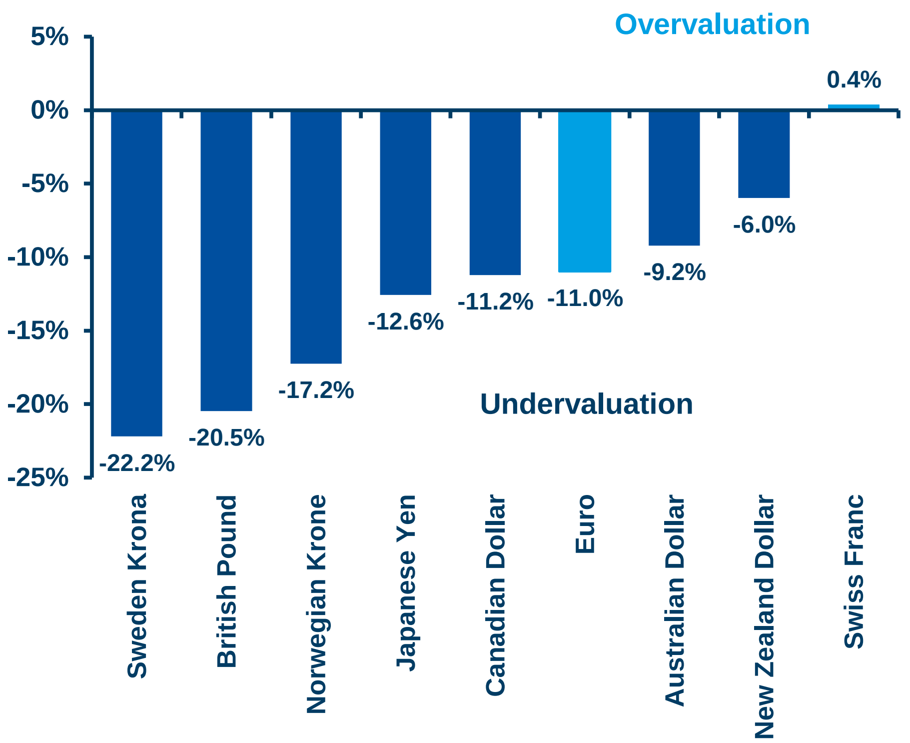
Euro Currency
Valuations and political risk

G10 FX valuations vs USD



EUR/USD and political risk

» The USD is overvalued vs the entire G10 universe (with the only exception of the CHF), but it showed some signs of weakening on Fed cut expectations.

Source: Amundi Research analysis on Bloomberg data. As of 29 August 2019.

Source: Bloomberg, Amundi Research. As of 29 August 2019.

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

Duration: a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates, expressed as a number of years.

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