Asset allocation: Amundi investment strategies

Why emerging markets may be the major story for 2016

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The main changes in our asset allocation deal with emerging markets (debt, equities and currencies). It is therefore necessary to explain the rationale behind our asset allocation.

Let's recall that the weakness of EMG asset classes for the past 4 years come from numerous factors:

- **Excessive capital inflows** during US QE. According to some estimations, EMG markets have drained more than 20% of the Fed's liquidity injections. This excess had to be corrected later;
- **Fed policy expectations**: EMG markets have been hurt with the end of the Fed's asset purchases programmes in 2013, and with the expectations of Fed tightening since 2013;
- **Oil price counter shock**: the negative effects of the oil price drop were doubts / risks on some countries, sectors, companies and banks, especially in commodity-producing countries;
- **China**: the economic slowdown since 2012, and the debate on hard landing vs. slowdown were among the major factors which drove EMG markets down;
- **Yuan**: fears of a massive devaluation, doubts regarding its capacity to stabilise the yuan vs. a basket of currencies;
- **US growth**: consolidation vs. slowdown vs. recession fears;
- **Specific risks and recession** in some of the so-called BRICS group (Brazil, Russia);
- **EMG currencies** have been in decline since 2013, an additional reason for debt and equities to weaken further;
- **Downward revision in world growth** in 2014, 2015 and 2016;
- **Capital flows out of EMG markets to advanced economies**: the decoupling between EMG and advanced countries offered new opportunities: better economic conditions in Europe drove capital flows away from EMG to Europe, while the risk/return expectations turned negative for EMG vs. advanced countries.

As a consequence, capital flowed out of EMG markets, and this "block" became a neglected asset class... and all international portfolios chose to underweight the EMG as standard policy. During this period, selectivity was key: it was better to prefer commodity-consuming countries, countries able to have autonomous growth, with low external debt and, if possible, undervalued currencies. As usual, in such cases, valuation turned excessively low for some equities/companies/debt/currencies.

Three key questions at this stage:

1. What are the prerequisites for EMG to be a success story?

2. What are the key features of EMG countries at this stage?

3. How to invest in such heterogeneous asset classes?

What are the prerequisites for EMG to be a success story?

Prerequisite #1: **Fed policy has to remain accommodative/softer than generally thought**

EMG markets are highly dependent on US rates, as seen again in 2013 and in 2015. EMG started to decline when rumours began about the end of QE and when the Fed announced its desire to hike interest rates. The Fed is now behind

The essential

This paper analyse the prerequisites for a rebound in emerging markets asset classes, and the positive key features of these markets. It also presents the different ways to invest in these countries and the Amundi approach. The emerging markets have been in a slump since 2013 (when investors began to fear the end of the Fed's QE) until February 2016 (when concerns that China would founder and/or devalue the yuan finally subsided). In the meantime, recession has hit the major emerging economies (especially Russia and Brazil), and the plunge in commodities prices has fuelled the decline in emerging markets and currencies.

Fears are gradually subsiding, the Fed is reassuring investors, the global and the US economies have so far avoided collapse, commodities are stopping their descent... In short, the advantages of emerging economies are becoming evident once more: clearly undervalued currencies, valuations that are sometimes excessively low, international portfolios that heavily underweight these countries' assets, generous interest rates and spreads in a world where yields are close to or below zero, and so on. Overall, capital flows are slowly returning and confirming our positive outlook on emerging market assets, whether they are equity, debt or currency instruments. However, some caution is still warranted: there are still some specific risks, such as Brazil, which is embroiled in a political scandal that will last for some time.

In the past few years, all international portfolios chose to underweight the EMG as standard policy

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the curve and cannot tighten and restore its room for manoeuvre as it did in 2004-2006. As a consequence, the Fed should continue with a soft monetary policy, and QE4 if needed. On the other hand, central banks (ECB, BoJ, PBoC and the Fed) should continue to add liquidity, which represents a plus for EMG asset classes and risky assets.

Prerequisite #2: China: fears about growth and about the yuan are exaggerated

As seen above, China's slowdown is a fact. No hard landing expected so far. China will not devalue the yuan, and China's exchange rate policy is now stable. The Chinese central bank has recently changed the essence of its FX policy. PBOC has decided to manage the stability of the yuan vs. a basket of currencies. At the very least it is quite efficient. A stabilisation of growth and/or a decline in fears about China and the yuan (as is the case at present) represent positive messages for EMG asset classes.

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Prerequisite # 3: oil prices and commodities prices do not decline further and start to recover

1st comment: economies are experiencing the biggest counter-shock in the past few decades, with positive impacts.

- A positive impact for **commodity consuming countries**;
- A positive impact on businesses' **margins** and **profits**;
- It pushes **price indexes** further down, which provides greater leeway in monetary policy;
- It supports **growth** and **domestic demand** at a time when the latter is the main driver of growth.

2nd comment: two thirds of the decline in oil price is linked to supply-related developments.

It explains why it is so difficult to predict the price, which adds another range of uncertainty and volatility.

3rd comment: the bulk of world production of commodities is no longer profitable. The next step has to be either a rise in prices or cut in supply, or both.

In other words:

- The negative impact of the oil counter shock is over-estimated (positive impacts stronger than generally thought);
- The bulk of the fall is due to supply factors and not demand factors;
- The fall in commodities prices should come to an end soon.

This represents three positive messages for EMG countries and asset classes.

Prerequisite # 4: world growth does not fall further

World growth should be around 3%, both in 2016 and 2017, and no further slowdown or recession is expected. Russia and Brazil (at a later stage) should gradually exit recession, and GDP growth in EMG countries is expected to improve gradually.

Conclusion on prerequisites: with regard to the four prerequisites described above, EMG markets, both equities and debt, should be able to recover in 2016. When prerequisites are met, attractive key features of EMG markets will take the lead.

What are the key features of EMG countries at this stage?

1st key feature: EMG debt is seen as an oasis of rates and spreads in a environment of low/negative rates

Rates are negative in Japan all over the curve (except the 30 year bond, which is

close to zero, though). 35% of Barclays Euro global aggregate index (sovereign, quasi-sovereign, corporates and financials) bear a negative yield at present, with a small proportion of yields above 2%. EMG debt still has attractive yields and spreads, which is a "plus" for investors still chasing yields and spreads.

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2nd key feature: currencies are cheap, a reason to pay attention to EMG markets

The depreciation of EMG currencies started in 2013, when the end of the US QE was rumoured. Since then, all factors played for further depreciation (Russia, Brazil, China, CNY, commodities, Fed, world growth…). EMG currencies are cheap, with significant undervaluation in some cases. Switching from hard currency debt to local debt makes sense at this stage.

3rd key feature: FX regimes are flexible, a plus for EMG economies

EMG countries have adopted flexible exchange rates for some years. The depreciation of currencies has prevented severe internal devaluation (recession / depression) and favoured stronger recoveries. This is very different to past crises, when currencies began to depreciate in the last stages of the financial crisis, after economic activity collapsed.In other words, undervalued currencies are attractive.

4th key feature: debt in USD much lower than in the past

Any USD appreciation is not as disruptive as it used to be in the past. The structure of the debt has dramatically changed in the past 15 years, and sensitivity to the USD or to foreign currencies has declined.

5th key feature: oil down, USD up...

All in all, it is not as bad as generally thought for oil producers with flexible FX rates.

Conclusion on key features: in the past 3.5 years, EMG market asset classes have been completely neglected, due to the objective factors mentioned above and due to overestimation of some risks and fears. As is always the case with neglected asset classes, international portfolios are underweighted EMG markets, and valuations offer attractive entry points. While prerequisites are met, key features offer strong advantages.

How to invest in such heterogeneous asset classes?

The term "emerging markets" is unsatisfactory. It's misleading, because it tends to group countries together that have very different economic features and realities. What's more, it doesn't recognise the spectacular progress made by some of them. Finally, some of these countries are now in much better positions than so-called "advanced" countries. In fact, both "emerging country" and "advanced country" are confusing. This is especially unfortunate in the current situation, which requires, and even demands, a relative value analysis, off benchmarks, so great are the discrepancies and so dissimilar the countries' features.

There are several traditional ways to invest in EMG markets:

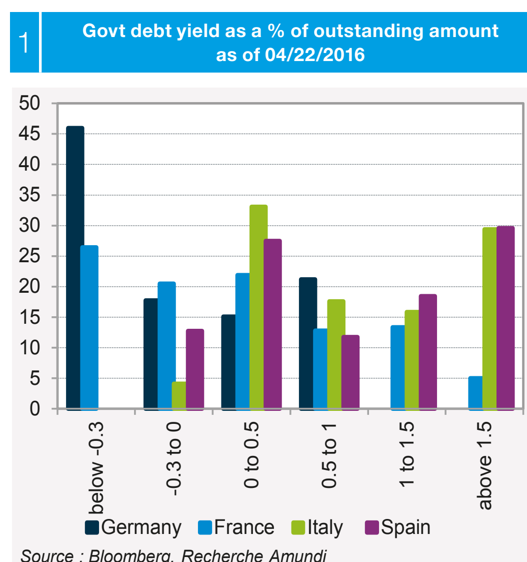
Traditional way # 1: the bloc approach

This approach opposes EMG bloc and advanced countries. This split is completely out-dated and has been so for a long time. The discrepancies and differences call for more detailed analysis. In times of crisis, the EMG block is a block, but in quiet periods, when investment in these countries is appropriate, it is not a block anymore: specificities, thematic, valuation gaps… drive the recovery. Moreover, some so-called EMG countries are in a better shape than some so-called advanced countries.

Traditional way # 2: the regional approach

This approach is inadequate even though there are common features: With commodity-hungry Asia, oil-producing GCCs, and EMG Europe stuck to

1 Govt debt yield as a % of outstanding amount as of 04/22/2016



Source : Bloomberg, Recherche Amundi

the EU… moving from one region to another in terms of investment isn't bad, but we can do much better.

Traditional way # 3: Benchmark/index and Sub-index approach

This approach forces to adopt concepts such as BRICS (Brazil, Russia, India, China and South Africa), Next11 (countries following BRICS, such as Turkey, Indonesia, Mexico, Philippines, Vietnam), New Frontier (25 countries considered to be the next wave of emerging countries such as Bangladesh, Bulgaria, Nigeria, Pakistan, Ukraine, Kenya, Kazakhstan, Argentina…). With this approach, investment would follow major benchmarks such as EMBI, EMBI+ EMBI Global Diversified, NEXGEM, EURO EMBI, CEMBI, CMBI Broad diversified, GBI-EM Broad, GBI-EM Global, GBI-EM Diversified… These approaches are not providing typologies or classification – they are merely indices or marketing approaches.

The Amundi approach: a "factor-investing" classification

We have published several studies (in 2012 and 2014), in the Cross Asset Investment Strategy Monthly in particular. Let's recall the basic components:

- A scoring gave the ranking of countries as regard numerous criteria such as the macroeconomic outlook, the quality of public balance sheets, investment and savings, vulnerability…
- A statistical analysis based on different measurements of proximity gave the capacity to group countries into different homogeneous blocs (with common factors).

Our approach is more interesting than traditional approaches for several reasons:

- It break blocks and groups to focus on factors and key features;
- It allows EMG countries to be mixed with advanced countries;
- Ultimately, the number of groups is smaller;
- We may find regional configurations, but not only those;
- Its graphic representation is telling;

The purpose of our approach is at least twofold;

- Define a typology specific to Amundi on the EMGs;
- Use this typology to play factors / themes. For example, since 2014, we recommended to invest in i) countries able to have autonomous growth (not too dependent to world trade and world growth), ii) commodity-consuming countries, iii) countries with low external debt, and iv) countries with undervalued currencies. To start investing in commodity producers, with low valuation, low weights in portfolios and undervalued currencies make sense at this stage.

Conclusion

The international context allows investors to gradually come back into EMG asset classes, and to pay attention to their current (under) valuation. 4 comments to conclude:

1. Pay attention to capital flows: they re-enter EMG countries
2. Pay attention to portfolio positioning: the bulk of international portfolios are massively underweighted EMG, and a simple move to neutral position should favour a significant appreciation of these asset classes
3. Be positive on all EMG asset classes: debt (both local and hard currency debt), equities and currencies
4. Stay selective and reactive: EMG countries cannot be considered as a bloc, and some countries continue to bear specific risks: Brazil is at present one of the most representative example (see insert below).

Our asset allocation recommendations are unchanged this month. The table next page summarize our views, convictions, and positions.

> "International portfolios are underweighted EMG markets, and valuations offer attractive entry points"

> Brazil: an economic and political crisis, and a specific risk

While capital flows are gradually returning to emerging markets, sentiment toward these markets is improving, and Argentina had no problem raising large amounts of funds on capital markets ($15 billion with an order book of more than $60 billion), Brazil is experiencing its worst political crisis since it became a democracy. The impeachment proceedings against President Dilma Rousseff are continuing, while uncertainty grows.

Background:

- In **March 2014**, a federal police investigation suspects the Rousseff government and that of her predecessor Lula of establishing a system for secretly financing parts of the ruling coalition through bribery using public contracts. Several people have gotten rich off the scheme, which also involves members of the main opposition party, the Social Democracy party.

- In **December 2015**, the opposition launched impeachment proceedings. Dilma Rousseff is accused of window dressing government accounts in 2014, the year she was re-elected. The president is calling it an institutional "coup d'état", an accusation levelled against her own vice president, thought to be one of the instigators of the impeachment proceedings.

- On **17 April**, Brazil's lower house of congress voted to start impeachment proceedings, with 367 deputies voting "for" and 137 voting "against" (out of a total of 513).

- Finally, on **26 April**, the Senate formed a special committee tasked with analysing the impeachment proceedings

What happens now?

This committee of 21 senators has 10 days to come up with a recommendation for the 81-member Senate on whether or not to continue impeachment proceedings. The vote will be decided by a **simple majority (**41 out of 81 senators) during a plenary session that will **probably be held on 12 May**. An impeachment for a "crime of responsibility" would suspend Dilma Rousseff from her position for a maximum of six months until final judgement has been passed. According to the constitution, her vice president (and rival) Michel Temer (aged 75) would replace her for the six-month suspension period. Michel Temer is at best unknown and at worst unpopular, even in the current majority, because he has been accused of organising a "golpe" (coup d'état).

After 180 days, there will be a second Senate vote, in which a **2/3 majority** will be needed to push Ms. Rousseff out of office for good. In such a case, Michel Temer would then replace Dilma Rousseff, unless he himself is "caught up by events": his name has actually been mentioned several times by people charged in the Petrobras corruption scandal. Michel Temer's term could also be ended at the same time as Dilma Rousseff's by the Superior Electoral Court, which will make a ruling by 2017 on whether their campaign for the presidency/vice-presidency was partly financed by funds diverted from Petrobras. A new presidential election cannot therefore be excluded.

It is worth noting that Dilma Rousseff has not been accused of corruption, unlike many of the senators who will be deciding her fate. In fact, 39 of the 81 senators are under investigation, including 12 for the Petrobras scandal, notably the President of the Senate and third person in line for the presidency, Renan Calheiros. Fernando Collor de Mello, the former President of Brazil and current senator, and Aecio Neves, who ran unsuccessfully in the last presidential election, are both in the crosshairs of the justice system.

Conclusion

Brazil is solvent and has no desire to cut itself off from financial markets and trigger a default. However, its political crisis will most likely last for some time, holding back reform and measures required to emerge from the recession and better control public finances and government debt. We should keep in mind that i) growth will remain weak (-2.5%/3% in 2016 vs. -3.9% in 2015, and definitely negative on average over the next three years), ii) debt is already high (it's already at 65% of GDP and could go as high as 80% in the next three years) and III) the current situation is holding back reforms, particularly with regard to public finances. In other words, the probability that Brazil could default has clearly risen in the last six months. We must show caution with respect to Brazil: it poses a non-negligible specific risk.

> Macro Hedging Strategies

	1 mois change	0	+	++	+++
Long US Treasuries	↓	⊡	⊡		
Long Bunds	↓	⊡			
Long USD	↓	⊡			
Long JPY	↓	⊡			
Long volatility	↓	⊡	⊡		
Long cash USD	↓	⊡			
Long Gold	↓	⊡	⊡		

The recent developments (rise in the price of oil, easing of fears of a recession or a devaluation of the yuan, the stances taken by central banks, particularly the Fed and ECB, etc.) called for re-adding risk to the portfolios, and thus reducing macro-hedging strategies. We did it roughly two months ago and we keep this bias. Maintaining long-term exposure to volatility and US bonds (US dollar and carry trades) is still a reasonable approach. The yields reached on German bonds lead us to believe that maintaining a long position on Bunds is no longer one of the best macro-hedging strategies.

The table above represents a short investment horizon of one to three months. The changes (column 2) reflect the outlooks expressed at our most recent investment committee meeting. The lines express our aversion to risk and our macro-hedging strategies. They should be viewed in relation to the asset allocation tables. A negative outlook in terms of asset allocation will not lead to hedging. A temporarily negative outlook (negative in the short term but positive in the medium term) may lead us to protect the portfolio, without affecting our long-term outlooks. The application of the strategy is expressed by a position (+), and the scale of the position is expressed by a graded scale (+/++/+++). These strategies are independent of the constraints and considerations concerning the construction of the initial portfolio subject to protection. These are overlay positions.

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Asset allocation: multi-class outlooks and convictions

	1 mo. change	---	--	-	0	+	++	+++
Equities/gov. bonds	↑					⊡		
Corp. bonds/gov. bonds	↑						⊡	
Equities/corp. bonds	→					⊡		
Duration	→				⊡	⊡		
Corporate bonds	↑					⊡		
Oil	↑					⊡		
Gold	→				⊡			
Cash EUR	→			⊡				
Cash USD	→					⊡		

The table above represents an investment horizon of six to 12 months. The changes (column 2) reflect the outlooks expressed at our most recent investment committee meeting. The lines express our multi-asset class outlook for a 6/12 month horizon. The outlooks, changes in outlooks and opinions on the asset classes reflect the expected direction (+/-) and the strength of the convictions (+/++/+++); they are independent of the constraints and considerations that concern the construction of portfolios.

Asset allocation: relative outlooks and convictions by major asset class

		1 mo. change	---	--	-	0	+	++	+++
Equities	US equities	→			⊡	⊡			
	Japanese equities	→				⊡			
	Euro equities	→					⊡		
	UK equities	↓				⊡			
	Pacific excl. Japan	→				⊡			
	EMG equities	↑				⊡			
Gov. Bonds	US bonds, short	→		⊡					
	US bonds, long	→			⊡				
	Euro core, short	→		⊡					
	Euro core, long	→			⊡				
	Euro peripherals	↑				⊡	⊡		
	UK bonds	↓			⊡				
	Japanese bonds	→			⊡				
Corp. Bonds	US IG	→				⊡			
	US HY	→				⊡			
	EURO IG	↑				⊡			
	Euro HY	↑					⊡		
	EMG debt hard currencies	↑				⊡			
	EMG local debt	→			⊡				
FX	USD	↓				⊡	⊡		
	EUR	→				⊡			
	JPY	→				⊡			
	GBP	↓		⊡	⊡				

The table above represents an investment horizon of six to 12 months. The changes reflect the outlooks expressed at our most recent investment committee meeting. The different lines provide relative outlooks for each major asset class and absolute outlooks for forex and commodities. The outlooks, changes in outlooks and opinions on the asset classes reflect the expected direction (+/-) and the strength of the convictions (+/++/+++). They are independent of the constraints and considerations concerning the construction of portfolios.

Portfolio type

> Equity portfolios

- Beta of portfolio around 1
- Prefer Eurozone
- Neutral US and Japan
- Emerging markets: country selection is key, but a positive bias globally

  Within emerging markets:
  - Overweight India, Thailand, Peru, Europe, Philippines
  - Neutral on Indonesia, China and Russia
  - Underweight, Taiwan, Greece, Brazil, South Korea
- Maintain short bias in GBP,
- Increase long positions in EMG currencies

> Bond portfolios

- Maintain overweight position in credit, with a positive bias in favour of financials
- Globally neutral duration, with a long bias in Euro, and a short bias in GBP, USD and JPY
- Emerging debt:
  - Still prefer hard currencies debt (long USD)
  - Increase risk on local debt
  - Play thematics on EMG
- Maintain short bias in GBP, Long USD / Short JPY, Long JPY / Short EUR... but do not expect large fluctuations
- Increase long positions in EMG currencies

> Diversified portfolios

- Slightly overweighed equities
- Prefer Eurozone, neutral Japanese, slightly underweighted on the US equities
- Play value in Europe and quality in the US
- Stay overweight EMG equities
- Stay long US, but positions reduced (carry + macro-hedging purposes)
- Keep overweight position on sovereign bonds of peripheral Eurozone countries vs. core (close to fair value, though)
- Corporate bonds: neutral HY, slightly positive on IG
- Increase positions on emerging debt
- Long JPY reduced
- Increase long positions in EMG currencies

Risk Factors

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The table below presents 11 risk factors with probabilities assigned.
It also develops the most credible market impacts.

[RISK # 1] **What if the Fed took the wrong turn?** [PROBABILITY] **15%**

ANALYSIS The misinterpretation of the Fed's decisions remains a major risk factor. The Fed may well be cautious, and the differences of opinion within the committee had increased with the appearance of new relatively hawkish voting members. For several years now, central banks have made a practice of preparing financial markets and economies for changes in monetary policy. But the reversal of an ultra-accommodating monetary policy that has been in place for seven years carried particular importance. In our assessment, there is no pressing need for tightening or any type of monetary policy normalisation at this point. This view is at last largely shared, including amongst Fed governors (as hawkish members recently turned more dovish, and the very recent statements by Janet Yellen point in the same direction). The Fed must avoid a communication error. Markets could react poorly if rates are increased prematurely, excessively or without a sound rationale.

MARKET IMPACT Count on a sharp downturn in equities and on contagion into the emerging markets, which have already been weakened. Such a situation would widen spreads and rates between Europe and the US, and further weakening the euro, two arguments in favour of European risky assets.

[RISK # 2] **Hard landing by the Chinese economy** [PROBABILITY] **20%**

ANALYSIS China's business model has changed in the past decade. Growth is not as export-led as it used to be, and internal demand became the key driver for growth. Such a good move has some drawbacks: there are signs of excessive lending, debt is ballooning, industrial competitiveness has eroded and productivity gains are falling. In simple terms, potential growth is down. The question is not whether future and potential growth will be lower. That is already a given. Rather, it is whether growth risks falling sharply (and far) below its potential (5% at present vs. 10% 15 years ago)—in other words, whether China will experience a large-scale economic crisis. A more severe contraction of Chinese growth would add to an already long list of global deflationary pressures. The most recent indicators have reduced this risk.

MARKET IMPACT Such a scenario would have a very negative impact, and its cascading effects would be especially disastrous: vulnerability in the banking systems, vulnerability in the financial system, vulnerability from China's public and private debt, impact on commodities and emerging countries, impact on the currencies of commodity-exporting countries, advanced countries, and emerging countries… The Fed would cut its "tightening cycle" short, and the ECB would pursue its QE.

[RISK # 3] **Collapse of global growth** [PROBABILITY] **20%**

ANALYSIS A "hard landing" by the Chinese economy would mean a plunge in global growth, but other causes are possible. The continued decline in commodity prices and global trade, an excessively restrictive US monetary policy, and the structural weakness of European economic activity are all stirring fears of a decline in global growth. We (Amundi) are, despite major revisions from banks and international organisations, less optimistic in terms of growth forecasts than the consensus. The risk here is an even worse scenario, because it is about a dramatic slowdown in global growth. China would no longer be a source of confidence. Until now, the slowdown in the emerging world has been a tangible reality, while the "advanced" world has been moving forward for a few years now. Another slowdown in the "advanced world" could come from the secondary effect of the EMG countries (drop in exports), another dip in investment, jobs… in short, from domestic demand, at present the key driver for growth.

MARKET IMPACT Putting aside the use of expansionist economic policies, we may fear the return of a currency war, among the emerging countries on the one hand, and between the advanced and the emerging world on the other. Expect a dramatic underperformance by risky assets, equities, and credit.

[RISK # 4] **A recession in the United States** [PROBABILITY] **20%**

ANALYSIS We have mentioned on numerous occasions that the market consensus was too optimistic, and that we have recently witnessed widespread growth revisions for a number of countries and regions, including the United States. For our part, we revised our growth outlook in 2014, and we are anticipating growth of around 2% in 2016 and 1.8% in 2017 (the current level of potential growth). As for the United States, we must not forget that consumption (which represents more than 70% of GDP) continues to hold up well and that there is a big difference (which has often proved unsustainable over time) between the services sector (strong) and the manufacturing sector (weaker). The key issue is knowing whether or not this will be sustained. Leading indicators continue to argue that growth of approximately 2%, not a contraction, is in the offing. At this

Risk Factors

time, a recession in the United States is not a possibility, but what is worrying is the Fed's lack of room to manoeuvre, as it has been unable to raise rates until now. The current situation is totally different from 2004-2006. During those two years, the Fed managed to hike interest rates 17 times—a total of 400 basis points—giving itself leeway, which it was quick to use once the financial crisis hit. Today that context is very remote. The Fed is behind in its economic cycle and financial stability, and to a lesser degree the US dollar, cannot afford such interest rates hikes. How can the current slowdown be managed? Does the Fed still have credibility?

MARKET IMPACT A recession in the United States would be catastrophic for the global economy, and Europe, despite being in better health, would not be spared the impact. Short rates would remain low for a very long time and the Fed, some weeks ago, with no leeway in terms of conventional monetary policy, would have no choice but to go ahead with QE4. Do not expect a positive impact on risky assets. The initial impact will be negative, and the lack of credibility of central banks would certainly add volatility and stress. Expect further, and substantial, budget imbalances.

[RISK # 5] **Sharp devaluation of the yuan** [PROBABILITY] **10%**

ANALYSIS For a few days in the middle of last August, China gave the impression that it was abandoning its exchange rate policy, preparing the markets for a major depreciation of the yuan (in 1994, it devalued the yuan by 30%). These same fears reared their heads again in early January. Until now, China has used monetary policy, budgetary policy, fiscal policy, and revenue policy as stimulus tools, careful not to use the exchange rate policy. Moreover, it promised the G20 it would not, while the yuan will be part of the SDR starting October 2016. Beyond the very negative immediate consequences on the financial markets, such a decision (an abrupt devaluation of at least 10%) would, without a doubt, be interpreted as an admission of weakness in terms of the economic policy as a whole. A low probability, because China has clearly demonstrated its desire—and ability—to stabilise the currency vs. a basket, instead of preparing a vast devaluation. A moderate risk, but with potentially very great harm.

MARKET IMPACT In this type of scenario, expect a widespread downward movement in the markets. A surprise devaluation would be the start of a more intense currency war, especially in Asia. Monetary policies would become extremely accommodating to keep currencies from appreciating. A blow to the euro, and to the European economy, because EMG currencies make up more than 70% of its effective rate.

[RISK # 6] **Continued slowdown in the emerging economies (commodity prices fall again)** [PROBABILITY] **20%**

ANALYSIS Falling commodity prices, the dip in Chinese growth, and the coming shift in US monetary policy are all factors that are raising fears of a repeat of the 1997-1998 crisis (when emerging markets collapsed across-the-board). We should remember that emerging markets have been under stress since the US ended its QE programmes. Until now, only Asia had been able to withstand that stress, driven by the strength of the Chinese economy and its ability to curb difficulties. Corporate defaults and leading activity indicators have occasionally put the markets on high alert, but the resources brought to bear by Chinese officials (cuts in interest rates and in mandatory banking reserves, injection of liquidities, fiscal and tax measures, maintaining currency policy, etc.) ultimately put everything right. Now things are more complicated. Growth forecasts are being revised downward at regular intervals, and the risk is that domestic demand will unravel and economic policies will remain ineffective. This risk has nevertheless declined during the past weeks.

MARKET IMPACT This scenario would be a continuation of the trends seen at the beginning of the year, only worse for a number of emerging markets. Even though the drop in oil prices is a plus for commodity-consuming advanced countries, it is hard to believe that these countries would be totally isolated. With the decline in commodity prices, we should count on the continued decline in EMG currencies as well as capital flows out of the EMG. Choose asset classes from the advanced countries, and safe havens.

[RISK # 7] **A new European crisis** [PROBABILITY] **5%**

ANALYSIS During last summer's Greek crisis, strong disagreement emerged with regard to the economic governance of the Eurozone, the need for stimulus, the adoption of reforms as a response to the crisis and even the role of the ECB. The limitations of the European institutions were once again laid bare. One of the main reasons is that such crises—and their solutions—were simply never foreseen (or foreseeable) in the European treaties, while "dogma of convergence" did not prepare the institutions for such risk scenarios. The task now is to respond to challenges like Europe's governance deficit, the lack of coordination in budgetary policies, the failure of supervision of budgetary imbalances, competitiveness gaps between countries, the unfinished nature of the mechanism meant to support countries facing difficulty and the failure to appreciate the interdependence of member states (while the ECB's anti-contagion mechanism has evolved significantly, the same cannot be said on the budgetary front). In short, the illusion of convergence needs now to be addressed. A new European crisis, if it were to occur, would be fatal, unless there is a great leap towards federalism. Unfortunately, the

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discussions around the concessions granted to the UK do not point in this direction. These concessions have tempted other EU members, which have voiced their views loudly and clearly. Federalism vs. Europe "à la carte" vs. EMU breakdown… three very different scenarios. Greece is still a worrying factor, while the Brexit scenario might create an additional lack of cohesion between the EU member States.

MARKET IMPACT The negative impacts are all too well known: widening of sovereign and credit spreads, rise of volatility—only this time it would certainly be accompanied by a severe weakening of the euro. A new European crisis could very well confirm the scenarios of the zone breaking apart, or, at the very least, the weaker countries exiting it… unless the exit scenario tempts the most solid of them, which is highly plausible, because they will end up becoming tired – from a political standpoint – of economically and financially supporting the struggling countries.

[RISK # 8] **Liquidity crisis** [PROBABILITY] **20%**

ANALYSIS Aside from the risk scenarios outlined above, which could lead to the liquidation of positions and/or portfolios, it is worth recalling once again that the prevailing liquidity constraints call for additional caution. Since the 2008 financial crisis, the decline in investment banks' inventories, the regulatory constraints that have led major players to buy and retain large volumes of bonds, the reduction in proprietary trading and market-making activities and the domination of central banks through QE programmes have all "drained" the fixed-income markets, and closing a position or portfolio now requires more time (seven times longer than before the financial crisis of 2008 if we are to believe the Bank of England). Even though bid-ask spreads have tightened since the financial crisis (due to the drop in interest rates), tradeable volumes are down sharply, as is the speed of execution, two major reflections of liquidity—or the absence thereof.

MARKET IMPACT This needs to be incorporated into investment decisions and should be taken into account in portfolio-building constraints and stress tests. Expect exit or macro-hedging plans for the less liquid portfolio segments or those that are likely to become less liquid in a crisis.

[RISK # 9] **The financial markets misjudge their long-term rate forecasts** [PROBABILITY] **70%**

ANALYSIS This risk materialised, with 10 Yr bund yield back to 0.15%, 10 Yr JGB in negative territory and US 10 Yr also down. The markets have tended to systematically predict too many increases over the past three years, particularly when it comes to the United States. The end of the financial crisis, the recover y of economic activity and the anticipation of monetary policy tightening or inflation are the factors generally put forward in favour of such projections. However, potential growth is lower, the economic recover y is less robust than in previous episodes (investment is insufficient, the labour market remains too weak, wages are not rising enough, weak productivity gains…) and it is still too early for monetary normalisation. Furthermore, the excess of global liquidity is not about to dry up. Japan and the eurozone have not completed their quantitative easing programmes. The rate policies of China, India and many other countries remain expansionary. The Fed will remain cautious and the Bank of England is not close to adopting a policy of monetary tightening. And even if we assume that budgetary deficits are not closely tied to long-term rates, the widespread reduction of public deficits calls for maintaining long-term rates at low levels. Finally, the deflationary pressures are still very real, with weaker global growth, a decline in global trade, a drop in commodity prices, lower inflation and industrial prices that are stagnant at best.

MARKET IMPACT There are powerful factors keeping long-term rates low, and the significant "repricing" of projected long-term rates could continue, especially in the US, where it seems to us that expectations of rate increases are still excessive, and growth forecasts too optimistic. In other words, yield curves could remain flat longer than expected.

[RISK # 10] **Political and geopolitical risks** [PROBABILITY] **70%**

ANALYSIS Politically and geopolitically, the markets are now operating against a difficult backdrop: Syria, Islamic State, terrorist attacks and migrant flows are some of the forces weakening diplomatic ties among countries, especially in Europe. And the political situations in certain countries like Brazil and Turkey are not doing anything to ease the climate. The States' commitment, and most importantly the type of commitment, in the fight against Islamic State are currently under debate, and this will probably be the case in 2016. Renewed tensions between Saudi Arabia and Iran exacerbated this feeling of insecurity in early January.

MARKET IMPACT There is no doubt that there will be regular spikes in tension and volatility. The current political risks are clearly identified and specific, but will this be enough to impact growth prospects or orientations on the financial markets? Nothing is certain at this stage.

This document is solely for the attention of journalists and professionals of the press/media sector

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[RISK # 11] **Brexit** [PROBABILITY] **50%**

ANALYSIS United Kingdom (England, Scotland, Wales, and Northern Ireland) will vote for or against an exit from the European Union on June 23. An exit would represent an economic risk for UK: according to some estimates, UK would “lose” between 2.5% and 9.5% of its GDP. Trade volume and costs would be affected, specifically in financial services, chemicals, and automobiles, all sectors that are highly integrated in the EU. Easy to understand why most businesses plead against any Brexit scenario. On the political front, there is a good chance for Scotland could call for a new referendum in favour of independance. Note that a Brexit would not impact too much the EU, economically speaking (hardest hit would be those with close ties to the UK, especially Ireland, but also Luxembourg, Belgium, Sweden, Malta, and Cyprus). There is a political risk for the EU behind the Brexit: some EU members might be tempted to negotiate options with the rest of Europe (immigration, sovereignty, governance…). We do not have an outlook on the result of the referendum, as the opinion polls do not provide any assurance. Undecided voters will ultimately have the last say, and the outcome might hang on the persuasiveness of the leaders of the opposing camps.

MARKET IMPACT In the event of Brexit, and especially in case of a "hard exit" (end of trade agreements, end of the European passport for corporates…) we will see an additional weakening of the pound sterling and long-term GDP of the British economy, two factors that could prolong the monetary status quo: 50% of UK exports go to the European Union.