

July/August 2016



Asset allocation

**Brexit:**  
**the shock wave**

The renminbi:  
a key currency for EMEs

China property  
market

Labour market in  
the eurozone

**Equity market:**  
**earnings forecasts**

Japanese real estate

**US construction sector**

## Executive summary

## Insights

### Asset Allocation: Amundi's investment strategies

#### Post-Brexit in a few questions and answers

Page 4

After 43 years of membership in the European Union, the United Kingdom has voted in a referendum to withdraw. The purpose of this article is review the political and economic impacts on the one hand, and the impacts on the financial markets and asset allocations on the other. It addresses the main current concerns.

#### Risk Factors

Page 15

#### Macroeconomic picture

Page 20

#### Macroeconomic and financial forecasts

Page 21

## Brexit

### 1 Brexit: towards a recession in the United Kingdom and a slowdown of growth in the Eurozone

Page 22

The Brexit vote is a major source of uncertainty: the total lack of visibility will push economic actors to postpone their purchasing plans or decisions. This shock of uncertainty may send the British economy into recession while the slowdown should remain moderate in the Eurozone. We revise down our growth forecasts in Europe.

**> FOCUS > Uncertainty and growth: What do we know?**

## China

### 2 The renminbi, the new cornerstone of emerging currencies

Page 25

The monetary reforms adopted in 2015 by the Chinese authorities gave the trend in the renminbi unprecedented importance on the currency markets. The new Chinese currency regime led the currency markets into a new paradigm.

### 3 China Property Market: bubble or no bubble?

Page 29

How healthy the Chinese property sector is, fundamentally shapes the outlook for the Chinese economy with knock-on-effects on the global economy. With significant property inventory destocking over the past year, the bubble is diminishing to a larger extent. However, Chinese land prices are also rising significantly in some cities and regions, and we believe ever-rising land prices could lead to a potential property bubble.

## Eurozone



### 4 The labour market in the eurozone is definitely improving, and a little less slowly at that

Page 35

Unlike GDP, key labour market indicators in the eurozone still have a long way to go to return to their pre-crisis levels. Nonetheless, the positive spill-over of the economic recovery to the labour market is taking place, with clear signs of acceleration over recent quarters.

## Equity markets

### 5 Will earnings growth return next year?

Page 38

The equity markets were caught wrong-footed by Brexit. Some valuations have dropped sharply, but this is seldom reason enough to buy. This article assesses the credibility of consensus earnings forecasts. A review of sector contributions from 2015 to 2018 – quite uneven and more or less reliable – is highly instructive.

## Japan

### 6 Japanese real-estate and investors: a passionate but unstable relationship

Page 41

In an environment in which investment opportunities are becoming scarcer, real estate sector is to consider as it offers high level of dividend and the market has been expanding significantly. While office building has been growing due to economic expansion in recent years, warehouse assets have been benefiting more recently with new needs from logistics providers.

## Sectorial highlight

### 7 The US construction sector outlook still favourable

Page 43

Following the 2007-2009 real-estate crisis, the US construction sector just went through four years of relatively sustained growth. In a global environment that remains challenging, it is worth asking whether this rebound can go on, given that it has been a key driver of earnings growth for the major construction material groups.



## Asset allocation: Amundi investment strategies

### Post-Brexit in a few questions and answers

PHILIPPE ITHURBIDE, *Global Head of Research, Strategy and Analysis*

After 43 years of membership in the European Union, the United Kingdom has voted in a referendum to withdraw.

The market impact has been great. Within one week (from the reporting of the referendum's result to the morning of 30 June), the GBP lost almost 8% to the EUR (and -12% on the year to date). Meanwhile, European equities fell 5% (as measured by Eurostoxx) and safe havens like Bunds or US Treasuries posted sharp gains. Ten-year Treasuries and 10-year Bunds are now yielding, respectively 1.50% (-19bp) and -0.12% (-18bp). Corporate bond spreads have widened but this was offset at least partially by the interest rate impact. Bank securities (equities and debt), however, have dropped sharply, (-12%, for example, by the MSCI EMU financial index). As for sovereign spreads, the widening was held in check thanks to the ECB's QE. The Italian spread returned almost to its pre-Brexit level (+13bp, or 150bp above the 10-year Bund), while the Spanish spread actually narrowed a bit (by 5bp) to 138bp).

It is worth reviewing the political and economic impacts on the one hand, and the impacts on the financial markets and asset allocations on the other. The purpose of this research note is to address the main current concerns.

- QUESTION # 1 Can the UK stay in the EU despite the approval of Brexit via a referendum?
- QUESTION # 2 Could there be a second referendum?
- QUESTION # 3 Is a petition enough to reverse the process?
- QUESTION # 4 How can (should) EU countries react?
- QUESTION # 5 Will the coming negotiations between the UK and EU be decisive in Brexit's economic impact on the UK?
- QUESTION # 6 What are the political impacts of Brexit on the United Kingdom?
- QUESTION # 7 What are the direct economic impacts of Brexit on the European Union?
- QUESTION # 8 Could Brexit alone cause a global economic slowdown?
- QUESTION # 9 Does Brexit jeopardise banking systems in continental Europe?
- QUESTION # 10 Will Brexit have repercussions on the London financial sector?
- QUESTION # 11 What is the risk of a series of referendums in Europe?
- QUESTION # 12 Does Brexit make it more likely that accommodating monetary policies will continue?
- QUESTION # 13 Does Brexit reinforce the low-interest-rate environment and the quest for yield?

### The essential

**After 43 years of membership in the European Union, the United Kingdom has voted in a referendum to withdraw. The purpose of this article is review the political and economic impacts on the one hand, and the impacts on the financial markets and asset allocations on the other. It addresses the main current concerns.**

Our baseline scenario is: i) that the UK will trigger Article 50 and begin exit negotiations with the EU; ii) that a petition is not enough to cancel the results of the referendum; and iii) that there will be no second referendum. Damage to the European economy will be limited (no doubt to -0.3% of GDP spread out over at least two years). It will probably be worse in the UK, with a recession that will be worse if final negotiations produce restrictive agreements. Two key components here would be the loss of European passports and favoured trade status. Politically, the UK will suffer considerable damage in the short term. Will the future Conservative prime minister be pro-Brexit or anti-Brexit? Only time will tell. For the EU, managing the UK's exit, as well as immigration, growth and employment issues are major challenges that will (or will not) show the firmness and cohesion of the remaining 27 member-countries. Financially, this is the last thing the banks needed, as it comes on top of negative interest rates, high cost of capital, and the market's inability to make distinctions between banks and between banking systems. One thing is certain: central banks will stick to their accommodating monetary policies (the Fed in particular) or even move them up to the next level (ECB, BoJ, BoE, etc.)

#### QUESTION # 1 Can the UK stay in the EU despite the approval of Brexit via referendum?

Is it possible to imagine that a democratic country like the UK would not adhere to the outcome of a vote as important as this one and with such a high turnout? It seems unlikely. And yet, despite the referendum's clear

verdict, this option seems to have been put on the table. Yes, of the 650 MPs in the House of Commons, 479 came out in favour of “Remain”, but it’s hard to see how the government and Parliament could act against the wishes of almost 17.5 million voters. The lawyers are now going at it. Some are calling on the people’s representatives to decide, instead of the people themselves; in other words, MPs should vote before triggering the exit process. Others acknowledge that this is possible in theory but impossible in practice, as the people’s representatives must adhere to the decision of the voters, as in any democracy.

Under the current procedure, any country wishing to pull out of the EU must invoke Article 50 of the Lisbon Treaty (see box below). This opens the path to negotiating an exit from the EU (this is the only legal way out of the EU). To do so, it must serve notice of its decision to the European Council, which would take note of this decision. That is when negotiations would begin. That would be a challenge indeed, as this is shaping up as the most complicated divorce in history. This is no doubt the reason for the UK government’s stance (*“Only the UK can trigger Article 50. In my judgement we should only do that when there is a clear view about what new arrangements we are seeking with our European neighbours”*, in the words of George Osborne, Chancellor of the Exchequer). Moreover, David Cameron would rather leave this (burdensome) task to his successor and play for time. Remember that negotiations will begin as soon as the procedure is triggered and will last for up to two years if an agreement is reached and longer if necessary on the unanimous vote of EU member states. Barring unanimous agreement to extend the negotiations, the UK will be out of the EU with no trade agreements and no free-circulation agreements. Some feel that it is possible for the UK to never invoke Article 50 and to remain *de facto* in the EU. We see this as highly unlikely. But one thing is sure: EU member-states are not displaying much cohesion. Some (like France) want the Brexit procedure to begin as soon as possible, while others (Germany) are not in as much of a hurry. The final agreement with the UK must be approved by the 27 member-countries at a qualified majority.



Is it possible to imagine that a democratic country like the UK would not adhere to the outcome of a vote as important as this one?



### Article 50 of the Lisbon Treaty

1. Any Member State may decide to withdraw from the Union in accordance with its own constitutional requirements.
2. A Member State which decides to withdraw shall notify the European Council of its intention. In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union. That agreement shall be negotiated in accordance with Article 218(3) of the Treaty on the Functioning of the European Union. It shall be concluded on behalf of the Union by the Council, acting by a qualified majority, after obtaining the consent of the European Parliament.
3. The Treaties shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that, two years after the notification referred to in paragraph 2, unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period.
4. For the purposes of paragraphs 2 and 3, the member of the European Council or of the Council representing the withdrawing Member State shall not participate in the discussions of the European Council or Council or in decisions concerning it.
5. If a State which has withdrawn from the Union asks to re-join, its request shall be subject to the procedure referred to in Article 49.

### QUESTION # 2 Could there be a second referendum?

In theory, anything is possible. But do not expect the situation to bog down, leading sooner or later to a second UK referendum. True, the pro-Brexit British press has softened its tone and some pro-Brexit politicians are now proclaiming their fondness for Europe, but foot-dragging is out of the question (European countries are obviously against doing so), as is preparing a second



referendum. However, a second referendum is entirely possible... but in Scotland alone. This would be a referendum on whether to pull out of the United Kingdom. Nicola Sturgeon, the Scottish prime minister, has already announced that if the polls are favourable, she will call for a referendum and, if it's successful, to apply to join the EU. A Scottish pull-out would be very bad news indeed for the UK from an economic viewpoint, as the UK would lose the North Sea oilfields, which are located in Scottish territory.

**QUESTION # 3 Is a petition enough to reverse the process?**

A petition with more than 100,000 signatories can also have consequences: in such a case, Parliament may debate the issue (but is not legally required to do so). There is currently a petition circulating for a new referendum and stating that if one camp wins less than 60% of the votes and voter turnout of less than 75%, a new referendum must be held. This is the case, and the petition now has 3.9 million signatures. Keep in mind, however, that the petition was initially launched by a Brexiteer, before the referendum, at a time when "Remain" was ahead in the polls. This petition does not appear to be serious. An investigation has found that some signatories were minors, some were not British, and others were simply made up: 39,000 signatories from the Vatican's 900 inhabitants, 23,000 from North Korea, whose people have no Internet access, and so on. In short, not only do certain aspects of the petition invalidate it, it would not be enough to reverse the outcome of the referendum, but merely to lead to a Parliamentary debate. Not enough, then to go against the referendum's verdict.

**QUESTION # 4 Will the coming negotiations between the UK and EU be decisive in Brexit's economic impact on the UK?**

While everyone agrees that the British economy will suffer long-term damage from its decision to exit the EU (50% of its exports are sent to the EU, and they currently account for almost 70% of GDP, vs. 20% 40 years ago), negotiations with the EU will determine just how much so. There are several possibilities:

**1<sup>st</sup> scenario:** the UK retains access to the single market and its membership in the European Economic Area (EEA), as is the case for Norway, which, incidentally, contributes to the European budget and allows free circulation of goods and persons but is not bound by any free-trade agreements with the EU;

**2<sup>nd</sup> scenario:** the UK retains its membership in the European Free-Trade Association (EFTA), like Norway, but with trade agreements negotiated with the EU, like Switzerland. Keep in mind that Switzerland is subject to some restrictions, for example on access to the EU for its banking industry. This will be a crucial point for the UK;

**3<sup>rd</sup> scenario:** the UK does not get any special trade agreements but does get tariff-free status between the UK and the EU, as is the case of Canada, for example. Some Brexiteers want to lift tariffs with the EU.

**4<sup>th</sup> scenario:** the UK renegotiates trade agreements with EU partners, one by one. Remember that it takes four to 10 years to implement trade agreements.

The impact on GDP is expected to be quite negative, especially as if trade agreements are not rolled over. The UK would "lose" between 2.5% and 9.5% of its GDP, according to the UK Treasury, while the employers' association estimates that the EU alone contributes 4%-5% of GDP, or about GDP 70bn. Trade volumes and costs would be affected, specifically in financial services, chemicals, and automobiles – all sectors that are closely woven into the EU.

The British Treasury fears a 6% decline in GDP, a 4% decline in wages, and the loss of more than 800,000 jobs within two years. The Centre for Economics and Business Research nonetheless hopes that the UK will avoid recession, assuming a favourable policy mix (monetary and fiscal policy). No wonder the ratings agencies downgraded the UK (it has already lost its AAA rating).

We also understand better why the UK would rather reach an agreement (pre-negotiated before triggering Article 50) giving it sole control over its migrant

“ A second referendum is entirely possible... but in Scotland alone ”

“ Negotiations with the EU will determine just how much damage Brexit will do to the UK economy ”

flows and allowing it to forego contributing to the European budget and to hold onto the current trade agreements. In a word, it wants to obtain even more than what it had been granted prior to the referendum. Any chance of that happening? Not really.

**QUESTION # 5 How can (should) EU countries react?**

European countries must now show cohesion, and two major issues stand out.

**1<sup>st</sup> issue: get out of the stalemate that is emerging around the UK's intention – or lack thereof – to invoke Article 50.** It's up to the UK to do so. Barring that, negotiations cannot begin. Although they do not represent all of the EMU or the EU, Germany, France and Italy do agree that there will be no pre-negotiations with the UK. But the European Council has no way to force the UK's hand. Waiting for a new prime minister to take office (on 2 September) and for him or her to pull the trigger would leave Europe and its institutions in a stalemate. Who would have imagined that a country wishing to leave the EU would end up not following through? This once again raises issues on the Treaty's content and governance.

**2<sup>nd</sup> issue: show (soon) that Europe is not out of ideas.** Among EU countries, interests sometimes diverge, and electoral calendars hinder joint decision-making, while lofty, broken promises feed extremist votes. Angela Merkel, François Hollande and Matteo Renzi presented four priorities early this week: security, growth, youth, and tax and labour harmonisation in the euro zone. Nothing new there. The hard part is not laying out objectives but meeting those objectives. All this is underlain by other basic issues, such as the debt burden in some countries, disenchantment with Europe, the rise of extremism (on the right in core countries and on the left in peripheral ones), reforms in France, foot-dragging on EU banking union, fears of a pick-and-choose Europe, and so on.

EU countries must now demonstrate their willingness to tackle these issues and head off temptations of a pick-and-choose Europe that the Britons have stoked.

**QUESTION # 6 What are the political impacts of Brexit on the United Kingdom?**

During the campaign David Cameron often said that, in the event of a pro-Brexit vote, Article 50 must be triggered promptly, as negotiations with the EU promised to be long and hard. Since the outcome of the referendum, his political agenda has changed. He announced he would resign in October but refuses – at least for now – to invoke Article 50 of the Lisbon Treaty, which would give the go-ahead to Brexit negotiations. He does not want to be held accountable for a political act that would most likely drive the British economy into recession, leaving this for his successor, probably a Brexiteer. Meanwhile, resignations are coming one after another within the Labour Party. All parties appear to have been shaken by the situation. We are therefore entering a phase of political instability that is blackening the picture a little more, especially as many Europeans want to get this over with as soon as possible.

On top of all these complications, the next prime minister will have to deal with a number of domestic splits:

- A sharp split between urban and rural areas: major cities like London voted 75% for “Bremain”, while more rural areas voted 75% for “Brexit”;
- A split between generations: most young people voted “Remain” and seniors “Leave”;
- A split between countries: England (at 53.5%) and Wales (at 52.5%) in favour of leaving; Scotland (at 62%) and Northern Ireland (at 56%) for staying;
- A split within the very heart of political parties, whether they were for “Leave” or for “Remain”. The shockwave has begun to be felt, with some leaders resigning and some serious dissension being aired;

“ One thing European governments need to do: show that Europe is not out of ideas ”

“ All parties appear to have been shaken by the situation and we are entering a phase of political instability in the UK ”



In other words, the referendum's outcome will have a lasting impact on British society. Moreover, the EU referendum may give way to a UK referendum. Scotland (where most oil is produced, among other things) has already announced that it wants to stay in the EU, which points to a new referendum.

We know the next prime minister will be a Conservative, and will be a woman. What we don't know yet is whether she will be pro-Brexit or pro-Bremain. This will no doubt make a difference in negotiations and could also drive the financial markets in the coming weeks, through public statements and poll results. So there is more political instability to come in the UK. The start of the voting process within the Conservative Party has named Theresa May (Home Secretary, pro-Remain) and Andrea Leadsom (Energy and climate change minister, pro-Leave). The final verdict is set for 9 September.

### QUESTION # 7 What are the direct economic impacts of Brexit on the European Union?

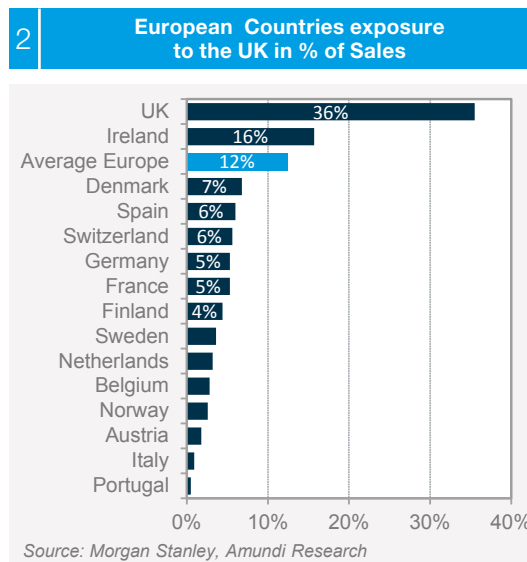
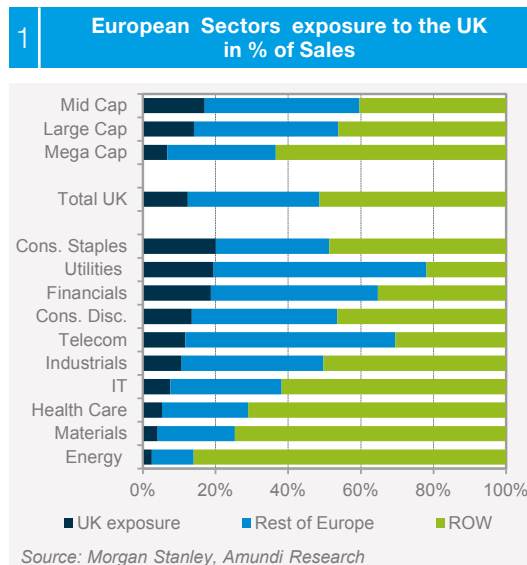
The EMU will now account for 86% of the EU's GDP (vs. 71% previously, when including the UK). At first glance, Brexit will not have serious economic repercussions for EU countries, particularly as growth is driven mainly by domestic demand. However, a look beneath the surface shows that Brexit will have visible impacts, which will vary somewhat from one country to another.

There are three main angles:

- Angle #1: impact on exports: Ireland, Malta and Chypre, as well as the Netherlands, Belgium and Norway would be affected the most;
- Angle #2: impact on direct foreign investment: Malta, Ireland, Luxembourg, Chypre, Switzerland, Belgium and the Netherlands would be affected the most;
- Angle #3: impact on the financial sector: Luxembourg, Switzerland and Malta would be affected the most.

Country	Exports to the UK (as a% of GDP)
Ireland	10.6%
Cyprus	7.5%
Norway	7.4%
Malta	7.1%
Belgium	6.8%
Netherlands	6.7%
Luxembourg	5.3%
Lithuania	3.9%
Hungary	3.5%
Germany	2.8%
<b>MEDIAN</b>	<b>2.8%</b>
Spain	2.7%
Sweden	2.7%
Denmark	2.7%
Latvia	2.5%
France	2.0%
Finland	1.8%
Italy	1.6%
Austria	1.5%
Switzerland	1.3%
Canada	0.8%

Source: S&P, June 2016



All in all, Ireland, Malta, Cyprus and the Benelux countries would be affected the most by Brexit, and Austria, Italy and Finland the least, as they are the least connected with the UK. All in all, we believe Brexit will have little impact on euro zone growth. We estimate euro zone growth at 1.5% in 2016 (vs. 1.6% previously) and 1.3% in 2017 (vs. 1.5% previously).

Lastly, remember that the UK contributes 200 million euros each week to the European budget, an amount that will have to be taken over by EU countries, prorated to their current contribution. That shouldn't be insurmountable at this point.

**QUESTION # 8** Could Brexit alone cause a global economic slowdown?

The British economy will no doubt sink into a recession in the next two years. Even if its growth stays in positive territory in 2016 and 2017, it is very likely to suffer at least two consecutive quarters of contraction. Will this be enough to send the global economy into a general slowdown? Probably not. As the world's fifth largest economy before the drop in the GBP, the British economy is not big enough to cause a global economic slowdown. Growth in other developed economies is solid enough to head off a new collapse in global growth. Keep in mind also that growth in many countries is currently being driven more by domestic demand than exports (especially exports to the UK). As for "emerging" economies, the impact will be too weak to make any radical change. All in all, global growth will remain at about 3%, and dangers will come from elsewhere: China, the United States, geopolitical risks, etc., and these are the risks to global growth, not the consequences du Brexit:

- In developed economies, weak investment, Chinese growth, and a possible slowdown in consumption remain major risk factors.
- In emerging economies, Fed monetary policy, Chinese growth, commodities prices and global growth expectation are the main risk factors.

**QUESTION # 9** Does Brexit jeopardise banking systems in continental Europe?

European banks are nothing like the banks of 2008 or 2011. Not only have they raised very heavy amounts of equity, but the ECB's anti-crisis mechanism is now well established, with bank supervision, stress tests and so forth. Moreover, for more than one and a half years they have had access to ECB liquidity, something that has reduced specific and systemic risk considerably.

- **Surveillance of banking systems** has improved considerably since the financial crisis, along with disclosures in this area. The ECB has undertaken a full and extensive audit; stress tests have been reassuring, and risks well identified;
- European banks are **now well-capitalised**: they have raised €500bn in equity since the crisis;
- Last 10 March, the ECB launched a **new TLTRO programme**, which provided reassurance on central bank support for euro zone banks;
- **Credit exposure is nothing like it was in 2008**: we have moved from a credit bubble to a credit "deficit".

Banks nonetheless remain weakened by the fall of interest rates into negative territory and the stubborn relatively high cost of capital.

And yet, **falling interest rates** were effective at first. Banks were given immediate access to very low financing costs and, more importantly, without relation to their real risk level. True, some banks early in the crisis had a hard time securing funding on the interbank market and all banks' share prices collapsed, but in the US and Japan as well as in Europe non-conventional policies at first boosted bank profitability. QE programmes sent bond yields down sharply, while deposits are of a far shorter duration than bank portfolio assets. Abundant liquidity and persistently low interest rates in some cases allowed banks to put off shoring up their balance sheets. In a second stage, lower yields and the flattening of the yield curve led to an outright collapse in



Ireland, Malta, Cyprus and the Benelux countries would be affected the most by Brexit



Global growth will remain at about 3%, and dangers will come from elsewhere: China, the United States, geopolitical risks, etc



the interest margin and profitability receded. In other words, the interest rate gap between (short) liabilities and long (assets) almost vanished.

Meanwhile, banks' cost of capital did not decline, for several reasons:

- **The weight of past crises:** the return to normal never actually happened, as the 2011-2012 bank crisis left long-lasting traces;
- **Fears of future crises:** the banking environment is still weak in some countries (Italy with its bad bank and Portugal) and there are persistent fears and rumours surrounding Deutsche Bank);
- **Regulatory uncertainty** is another reason that cost of capital has remained high. What will Basel 4 ultimately look like? At the very least, regulations, whose purpose is to prevent future crises, do not foster growth and the business cycle. This is the usual debate over the pro-cyclical nature of regulations;
- **The market's failure to make distinctions between different banking systems.** Regarding banks, there is still talk of systemic risk, interactions and contagion. None of that helps the interbank market function properly, and even undermines the weakest banks and thereby impacts the most solid banks through contagion! This vicious circle is encouraging deleveraging and domestic retrenchment more than fluid exchanges, pooling of risks, and the assumption of additional credit risk. By weakening UK banks, Brexit will raise fears of contagion, even though the coming challenges facing UK banks offers European banks some opportunities.
- **The "abnormally" low level of interest rates and yield curves,** with a direct impact on profitability and, hence credit supply. We might also add interest rate risk, which is now totally asymmetric. The more that banks believe that interest rates will remain low for a long time, the more they will be encouraged to dial back risk and ride against the tide of monetary policy.

The British financial sector – and banks in particular – will be weakened by Brexit, due mainly to their loss of European passports, the potential impact on the London financial market, and the prospect of a UK recession. If European banks are being undermined, that is due to the inability to make distinctions between different banking systems and additional squeezes on short- and long-term interest rates. But there's no point in betting on a collapse of European banks. Rather, attention should be focused on their excessive undervaluations.

**QUESTION # 10 Will Brexit have repercussions on the London financial sector?**

The London financial market will not be left unscathed, and that's why the City (and the Bank of England) was against Brexit.

- **The first consequence is that UK banks will very likely lose their European passports,** which allow a credit or payment establishment certified in one EU country to do business in other EU countries. With their passports revoked, London-based banks will have to be accredited elsewhere and will therefore have to transfer activities and employees, unless they wish to bet that their European passports will be spared in the EU-UK negotiations. But that's a bet not worth making, as the timing is too long and too uncertain. So some activities will be transferred, particularly at US and Swiss banks (some, like JP Morgan and HSBC have already raised this possibility), along with jobs (London employs 2.2 million people in banking and finance). Where will they go? To Ireland, Luxembourg, France, Netherlands, Germany, etc.? While the first two (Ireland and Luxembourg) offer tax benefits, major banking groups and first-tier asset managers have deep footprints in France.
- **The London Stock Exchange / Deutsche Börse merger could be cast into doubt** for economic and financial reasons (how much is LSE worth since the recent collapse in the GBP?). Could the German federal state of Hesse also use its veto right for political reasons (to block the merged entity from setting up in London)? Time will tell (soon).



European banks are being undermined by the failure to make distinctions between the different banking systems, and additional squeezes on short- and long-term rates



- So the key will be in the stance taken by European bodies. The EMU's major financial infrastructures are currently located in the EU but not the EMU, but this does not look realistic under the new paradigm. Is it still possible to allow entities that are crucial to the proper running of the euro zone to be located outside both the euro zone and the European Union? Unlikely. That means that the **Europeans will probably work to repatriate certain activities to Europe, and in particular the clearinghouses** (which handle and centralise payments between commercial banks).
- **The European Banking Association**, incidentally has already announced that it will relocate from London to the continent.
- **The European Central Bank (ECB) had announced a few weeks ago that the matter of the location of the euro market would not arise in the event of a Brexit.** The UK capital is the top global venue for currency transactions (including the euro), but it is also crucial for transactions involving euro-denominated corporate and sovereign bonds.

All in all, the London financial market is likely to lose some influence, as long as the Europeans, led by Germany and France, can be bothered to take over.

**QUESTION # 11** What is the risk of a series of referendums in Europe?

Brexit has revived expectations of referendums in other EU countries, backed by a number of opposition parties who see an opportunity to reject ruling parties. There have been referendums in many countries in recent years. **Slovenia, Slovakia, the Czech Republic, the Netherlands, Malta, Luxembourg, Lithuania, Latvia, Ireland, Hungary, Spain, and Estonia** have held referendums on a European constitution, the Lisbon Treaty or their membership in the EU, while **Portugal** and **Poland** cancelled theirs. **Scotland** is a special case: it wants to get out of the UK and stay in the EU, and a referendum there has become highly likely. Many people in Scotland feel greater affinity with Europe than with Great Britain and would like to create an independent and European Scotland. But things are not that simple. For one thing, the UK Parliament would have to green-light a referendum. For another, the transition period would be highly complex. First of all, Brexit includes Scotland. So not until the outcome of negotiations on the official exit of the UK would Scotland be able to request membership in the EU, assuming that it had become independent. This would be a long and uncertain process, involving the introduction of a national currency – not the GBP and probably not the euro, as Scotland would no longer even be in the EU. A real conundrum. Things are not necessarily any simpler in the other countries. In **Germany**, the Basic Law has no provisions on referendums on changes in federal state borders, mergers or demergers. Any referendum would be held in the states concerned. However, legislation in some states and local communities provides for local referendums. The **Belgian** constitution has no provisions for referendums. In **Italy**, 500,000 signatures are needed to hold a referendum, but the process takes at least one year... and referendums on treaties are not currently possible and the constitutional court will probably not allow any. Same thing in **Austria**, where treaties are not subject to referendums. In **France**, a national referendum (Articles 11, 88-5 and 89 of the Constitution) mainly covers legislation, treaties and constitutional issues. Only the president can call a referendum and, for the moment, his mind is on the presidential elections (next April and May). It's hard to see the Republican or Socialist parties taking this route after the presidential elections. Without the president's consent, support must be obtained from at least 25% of members of Parliament (National Assembly and Senate) and at least 10% of the voters. In **Finland**, 50,000 signatures can force parliament to debate but it is not required to call a referendum. In **Poland**, 500,000 signatures are enough to trigger a referendum, which cannot call for rejection of the provisions of a European treaty. In **Hungary**, 100,000 signatures are enough to trigger a referendum, but there can be no referendums against an EU treaty or against the obligations flowing from



The London financial market is likely to lose some influence, as long as the Europeans, led by Germany and France, can be bothered to make that happen



an international treaty. So we are unlikely to see a series of referendums but are likely to see these issues debated extensively.

**QUESTION # 12 Does Brexit make it more likely that accommodating monetary policies will continue?**

If there is one good thing about Brexit, it's that it reinforces the low-rate environment. Growth will weaken in the UK; the impact on trade is certain; and the fear of an impact on economies will encourage the major central banks to stick to their cautious stance.

Regarding the **Fed**, we have long known that no monetary normalisation or true tightening cycle is in the offing. The Fed is "behind the curve", and it has thus far not managed to restore its leeway on interest rates. True, the dollar's effective exchange rate has appreciated considerably (+13% since 2008), and acts as implicit monetary tightening. Fed models suggest that a 10% rise in the dollar's effective exchange rate is equivalent to a 175bp rate hike! An additional appreciation in the greenback, driven by its safe haven status (and the safe haven status of US Treasuries) would therefore act as additional implicit monetary tightening. However, on the year to date, the dollar (in real effective terms) has actually fallen by 0.6%. Even so, in the current context, the Eurodollar curve is now pricing in the next Fed Funds rate hike for 2017.

We also know that the **Bank of Japan** is being forced to stick to an ultra-low-rate (now negative-rate) policy and QQE (Quantitative and Qualitative Easing) to restart economic growth and inflation and steer the yen downward. Brexit has triggered a significant appreciation in the yen, as a safe haven. So the BoJ is nowhere near ready to reverse its monetary policy. In fact, it must now use exchange rate policy (through market interventions) to keep the yen down, as that would otherwise be bad news for profits, share prices and growth.

The **ECB** will continue to ensure that rates remain low for some time to come. Brexit's impact on euro zone growth is still not clear (everything will depend on UK-EU negotiations), but it will be visible.

The **Bank of England** probably has no choice but to ease its policy to head off the coming economic slowdown. At least, this is what can be gathered from the recent statements of the BoE governor, Mark Carney.

So much for those who were betting on rate hikes. They will probably lose that bet once again.

**QUESTION # 13 Does Brexit reinforce the low-interest-rate environment and the quest for yield?**

Clearly, yes.

- First of all, **Brexit is good news for US Treasuries**, which are safe havens, are denominated in USD (also a safe haven), and offer significantly better carry opportunities than European bonds. US bonds have received a boost during this murky episode;
- **Brexit is also good news for euro zone sovereign bonds**. To ease widening pressures on credit spreads and risk premiums, the ECB could speed up its asset buying programme, which makes it a good idea to reassume positions on the markets affected by the ECB's QE. With this in mind, being short duration and underweighted in safe assets is not a wise course.
- **And it is good news for euro zone corporate bonds**, especially investment grade ones, thanks to the ECB's buying programme. The ECB has accelerated the pace of its buying since the outcome of the referendum. This offers additional proof, in any were needed, of its determination to prevent an increase in risk premiums on the European corporate bond markets.
- **It's good news for high yield**, as this not only stabilises its environment (sovereign yields, IG spreads, etc.), it also gets good access to liquidity and to investors' further quest for yields.



We are unlikely to see a series of referendums but are likely to see these issues debated extensively



So much for those who were betting on rate hikes. They will probably lose that bet once again



- **Banks** are a special case. As mentioned above (in Section 9), lower rates and high cost of capital are two negative markets that have driven down banking stocks for some time now. Brexit now adds growth fears, additional declines in yields, and fears of contagion between banking systems. That's a lot to deal with in the current environment.
- **European equities** have also been driven down by financials and the repricing of risk premiums. The value story is now timelier than ever in Europe.
- As for **emerging markets**, we reiterate everything we have written over the past few months on spread and yield oases, equity and debt market valuations, undervaluation of numerous currencies, still-accommodating monetary policies, bottoming out of commodity prices, and so on, and are holding onto our positions.



The ECB is keep rates low and keeping risk premiums from worsening



## > Macro Hedging Strategies

	one-month change	0	+	++	+++
Long US Treasuries	→		▣		
Long Bunds	→	▣			
Long USD	→	▣			
Long JPY	→	▣			
Long volatility	→		▣		
Long cash USD	→	▣			
Long Gold	→		▣		
Long US TIPS	→		▣		

Those who decided to hedge their portfolios in the run-up to the UK referendum saw their cautious stance pay off. The drop in sterling, banking stocks and equities in general was considerable. The ECB's presence limited the damage to fixed-income, especially as it sped up its purchases, particularly of corporate bonds. As yields fell at the same time, the impact on spreads was at least partly offset by interest rates. Remarkably, Spain's spread vs. Germany even narrowed during this period of stress. **It is still a good idea to stay long volatility, long gold, long US bonds (dollar and carry), long core-Europe bonds and long duration.** The market rally has been healthy but no doubt still shaky. The agenda is eventful in the UK with the choice of a new prime minister in September and in the rest of Europe (managing Brexit, immigration, growth, and unemployment, etc.).

*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.*



## Asset allocation: multi-class outlooks and convictions

	1 month-change	---	--	-	0	+	++	+++
<b>Equities/gov. bonds</b>	→					□		
<b>Corp. bonds/gov. bonds</b>	→						□	
<b>Equities/corp. bonds</b>	→					□		
<b>Duration</b>	→				□			
<b>Corporate bonds</b>	→					□		
<b>Oil</b>	→					□		
<b>Gold</b>	→					□		
<b>Cash EUR</b>	→			□				
<b>Cash USD</b>	→				□			

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 month-change	---	--	-	0	+	++	+++
<b>Equities</b>	US equities	→			□			
	Japanese equities	→			□			
	Euro equities	→				□		
	UK equities	→			□			
	Pacific excl. Japan	→			□			
	EMG equities	→					□	
<b>Gov. Bonds</b>	US bonds, short	→				□		
	US bonds, long	→				□		
	Euro core, short	→		□				
	Euro core, long	→					□	
	Euro peripherals	→					□	
	UK bonds	→			□			
	Japanese bonds	→			□			
<b>Corp. Bonds</b>	US IG	→				□		
	US HY	→				□		
	EURO IG	→				□		
	Euro HY	→				□		
	EMG debt hard currencies	→				□		
	EMG local debt	→				□		
<b>FX</b>	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
- Slight preference for Eurozone (neutral on financials and underweighted utilities) vs. US
- Emerging markets: country selection is key, but a positive bias globally. Within EMG countries:
  - Overweight India, Thailand, Peru, Europe, Philippines, Korea, Russia
  - Neutral on Indonesia, Brazil
  - Underweight, Taiwan, Greece, , South Africa, China, Malaysia
- Long positions in EMG currencies

### > Bond portfolios

- Maintain overweight position in credit
- Reduction of positions on financials
- Duration: globally neutral, with a short bias on negatively yielding segments and a short bias in GBP and JPY. Long bias in core Euro
- Emerging debt:
  - Still prefer hard currencies debt (long USD)
  - Increase risk on local debt
  - Play thematic on EMG
- Maintain neutral bias (at best) in GBP
- Long USD vs. EUR
- Increase long positions in EMG commodity currencies (RUB, BRL, MXN), prefer to short some Asian currencies (CNY, KRW, TWD). Neutral EMG Europe

### > Diversified portfolios

- Global risk slightly reduced
- Portfolios globally neutral equities
- Long positions on Eurozone equities reduced
- Neutral Japanese and US equities
- Play value in Europe and quality in the US
- Stay overweight EMG equities
- Keep overweight position on sovereign bonds of peripheral Eurozone countries vs. core (close to fair value, though)
- Keep long US, but positions (carry + macro-hedging purposes)
- Corporate bonds: positive on HY and on IG
- Long positions in EMG currencies via local currency debt

## Risk Factors

PHILIPPE ITHURBIDE, *Global Head of Research, Strategy and Analysis*

The table below presents 14 risk factors with probabilities assigned. It also develops the most credible market impacts.

### [RISK # 1] What if the Fed took the wrong turn?

[PROBABILITY] 20%

**ANALYSIS** The misinterpretation of the Fed's decisions remains a major risk factor. This is all the more true given that, in half of cases (six out of the last 12 times), since 1945, monetary tightening cycles have been followed by a US economic recession within two years. This is undoubtedly what the market is fearing in the event that the Fed moves too quickly and, in particular, too strongly. For the moment, the Fed remains cautious. It is well aware that growth levels and the current cycle have not up until now warranted a significant increase in rates, and, that the reversal of an ultra-accommodating monetary policy that has been in place for eight years carries more importance than usual. In addition, the recent British referendum is pushing all central banks into a conservative stance. In the Fed's case, the point is to keep the dollar from appreciating (the Fed's models show that a 10% appreciation in the real effective dollar is equivalent to 175 bp in monetary tightening). Inflation indicators were approaching the Fed's target, and the central bank was preparing the markets for tightening over the summer. This will not happen; the euro-dollar curve has pushed the next monetary tightening to 2017. The Fed must avoid any communication errors. Markets could react poorly if rates are increased prematurely, excessively or without a sound rationale.

**MARKET IMPACT** If the Fed fumbles, we will have to 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 weaken 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 domestic 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 (between 3% and 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. 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 (about 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, but its recent momentum has been positive). The key issue is knowing whether or not this will be sustained. Leading indicators continue to argue that growth of approximately



## Risk Factors

2%, not a contraction, is in the offing. At this 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 rate hikes.

**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, with no leeway in terms of conventional monetary policy, would have no choice but to go ahead with QE4. This is what Janet Yellen seemed to be implying nearly two months ago. 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] **5%**

**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 income 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. China's top challenge now is opening its capital account: attracting international investors means accepting a less-independent monetary policy, a more volatile exchange rate, different rules between the onshore market and the offshore market, more volatile capital flows, less easily administrated markets that are more dependent on international investors, greater transparency on the state of businesses, and, specifically, State-owned businesses... in short, a fairly radical change in governance.

**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: the rise in oil prices and the influx of capital have given these markets fresh colour.

**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 tied to Brexit

[PROBABILITY] **10%**

**ANALYSIS** The European institutions are regularly showing their limits because the “dogma of convergence” did not prepare them for such risk scenarios. The task was 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). The recent UK referendum adds a new layer of uncertainty. Managing the UK's exit from the EU is akin to managing the most complex divorce in history. One thing is sure: this is an important test of Europe's

## Risk Factors

capacity to (once again) manage a crisis, convince Europe that there is a plan for it, and remove any attempts at a Europe "à la carte" that could pop up here or there in the EU. A new European crisis, if it were to occur, could be fatal, unless there is a great leap towards federalism.

**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] Greater financial instability

[PROBABILITY] **50%**

**ANALYSIS** Action by central banks has enabled financial stability to return. Lower short- and long-term rates, reduced volatility and tighter credit spreads are all factors that have generated an environment of greater stability. However, beware. This stability has a contrived aspect that should not be underestimated. Central banks cannot resolve all of the problems by themselves (jobs, investment, growth, etc.) and, if the current conditions do not improve more significantly, a certain level of disillusion/disappointment may well set in, which could in turn become a source of instability.

**MARKET IMPACT** In this situation, we should expect a rise in volatility and credit spreads, particularly in Europe, where the labour market is weaker and the political and social risks are greater.

### [RISK # 9] 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. Remember, the less liquid the markets are the less prices reflect fundamentals, the more they can be manipulated, the higher the risks of contagion are, the higher and more unstable volatility is, and the lower their capacity to absorb shocks. Not exactly reassuring.

**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 # 10] The financial markets misjudge their long-term rate forecasts

[PROBABILITY] **30%**

**ANALYSIS** This risk materialised, and anticipations regarding the Fed and long-term rates were revised downward. And that is the direction in which we are adjusting the risk of seeing the markets make the same mistake: there are plenty of arguments in favour of maintaining rates (long and short) (structural factors, institutional factors (central banks' attitudes), and cyclical factors), which explains why 10 Yr bund and JGB rates moved into negative territory (-0.10% and -0.26%, respectively), and the US 10 Yr was also down (1.43%). The markets have tended to systematically predict too many increases for close to four years now, particularly when it comes to the United States. The end of the financial crisis, the recovery of economic activity and the anticipation of monetary policy tightening or inflation were the factors generally put forward in favour of such projections. However, potential growth is lower, the economic recovery is less robust than in previous episodes (investment is insufficient, 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 already announcing new rate cuts in response to BREXIT.

**MARKET IMPACT** There are powerful factors keeping long-term rates low, and even if we may see "repricing" of long-term rates from time to time, as news, rumours, or economic indicators warrant, yield curves could remain flat and low longer than expected.

### [RISK # 11] Banks collapse

[PROBABILITY] **10%**

**ANALYSIS** This risk seems highly exaggerated to us. Still, we are not optimistic: negative rates are penalising the banks, the high cost of capital reflects the weight of past crises, fears of a new crisis, uncertainty over regulation, and the difficulty for investors



## Risk Factors

to discriminate against banks and against banking systems) are the primary factors in the banks' underperformance – an underperformance amplified by BREXIT precisely because it adds uncertainties over growth. Nor are we overly pessimistic. The banks of 2016 have nothing in common with the banks of 2008 or 2011: not only have they raised very large amounts of capital, but the ECB's anti-crisis system is now well-established, with banking supervision and stress tests. Moreover, the ECB's liquidity access facilities have drastically reduced specific risk and systemic risk for more than a year and a half. However, it is easy to show the close link between the banks underperforming and long rates dropping into negative territory, and the question that arises is, in fact, how well the banks can contend with rates staying in negative territory. We do not anticipate a collapse, but rather pressures on profitability, increased by the issue of digitalisation, which is pushing the banks to reduce their debt and remain conservative on credit.

**MARKET IMPACT** Among the factors causing fragility, the inability to discriminate is no doubt the most upsetting: rumours about a German bank, bad news on Italian and Portuguese banks, all of it causes waves of stress, widening spreads, and plummeting bank securities. No need to go into detail on the implications on financial stability or the economies if there should be any bank failures.

### [RISK # 12] 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. Renewed tensions between Saudi Arabia and Iran were already exacerbating 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 have zero impact on growth prospects or on the financial markets? Nothing is certain at this stage.

### [RISK # 13] The post-Brexit outlook involves significant and lasting political backwash

[PROBABILITY] **60%**

**ANALYSIS** The United Kingdom has voted: withdrawal from the EU is underway, even though two nations oppose it (Scotland and Northern Ireland). Estimates are predicting a significant negative impact on GDP. According to some estimates, the 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. The Brexit camp is deeply divided, with protectionists in favour of closing the country's borders and free-trade advocates looking to renegotiate trade agreements. The political skies have darkened: we know that the next prime minister (early September) will be conservative, but we do not yet know if he or she will be a defender of the "Leave" (Michael Gove, current Secretary of State for Justice, for example) or the "Remain" (for example, Theresa May, current Home Secretary). As such, we have not seen the last of the political instability in the UK. Note that a Brexit is not likely to impact the EU too much, economically speaking (hardest hit would be those with close ties to the UK, especially Ireland, but also Luxembourg, Belgium, Sweden, Malta, and Cyprus, if we look at the angle of exports, direct investment flows, and the financial sector). The risk is primarily a political one: that other European countries might extol a Europe "à la carte," and/or demonstrate deep divisions in terms of how to handle the UK's exit.

**MARKET IMPACT** In such a case, we will see additional weakening of the pound sterling and long-term GDP of the British economy, two factors that could prolong the monetary status quo. Without a doubt, we would also see increased fragility in eurozone financial assets.

### [RISK # 14] Fears of a domino referendum effect in Europe

[PROBABILITY] **40%**

**ANALYSIS** The Brexit has breathed new life into expectations of referendums in various European Union countries, reinforced by the statements of numerous opposition parties who see in this opportunity the possibility of preparing a vote to oust the powers in place. Scotland is a special case: wanting to cut itself out of the UK and stay in the EU, it is very likely that another referendum will be held. More profoundly European than British, there are many who believe in an independent, European Scotland. However, the situation is not quite that simple: first, the British Parliament has to approve such a proposal, but in addition, the transition period would be very complex. For one thing, the UK's exit from the EU also involves Scotland. Therefore, it will have to wait until the end of negotiations and the UK's official exit before Scotland, assuming it then becomes independent, can ask to join the EU. It is a long and treacherous process, because then they will have to prepare the introduction of a national currency. It won't be sterling, and probably not the euro either, because Scotland will no longer even be in the EU. It's a real puzzle. In Germany, the fundamental law does not provide for referendums except to change the borderlines in the Länder, merging or dividing them. The referendum takes place in the relevant territories. However, depending on the laws of the different Länder and communities, local referendums are authorised. The Belgian constitution does not provide for the option of a referendum. Italy requires 500,000

## Risk Factors

signatures before a referendum can be held, but the official process takes at least one year, except that referendums on treaties are not currently an option, and the constitutional court will surely not permit it. The same goes in Austria, where treaties are not covered by referendums. In France, national referendums (Articles 11, 88-5, and 89 of the Constitution) cover legislation, treaties, and the constitution. Any referendum is held at the President's initiative, and for the time being, it is the presidential elections that count (next April-May). It is hard to imagine the Republican Party or the Socialist Party going down such a path after the presidential elections. In Finland, it takes 50,000 votes to force a Parliamentary debate, but that does not have to happen via referendum. In Poland, 500,000 signatures are enough to trigger a referendum... except if it pertains to rejecting the terms of a European treaty. In Hungary, 100,000 signatures are enough for a referendum, but there cannot be any referendums against an EU treaty or against the obligations resulting from an international treaty. In clear terms, there is little likelihood of a referendum in any of these countries, but there is no doubt the topics will be debated.

**MARKET IMPACT** At least in the short term, the outlook on referendums or motions for referendums will weaken the powers in place, who are often reluctant to carry out such votes. This is especially the case with important elections coming up in France (presidential elections on 23 April and 7 May 2017) and Germany (federal elections between August and October 2017), to name but two. Debates over any referendums will probably not be enough to weaken the euro or sovereign and credit spreads..

## Macroeconomic picture

JULY		
AMERICAS		RISK FACTORS
<b>UNITED STATES</b>	<p><b>The recovery will continue, but gradually slow down.</b></p> <ul style="list-style-type: none"> <li>&gt; Gradual slowdown in the recovery due to less sustained growth in consumption.</li> <li>&gt; Virtually full employment and the erosion of corporate margins (from very high levels) will slow down the labour market's rate of improvement. In terms of overall purchasing power, moderate wage acceleration will not offset the slowdown in job creations. The purchasing power gains associated with oil prices in 2015 cannot be repeated.</li> <li>&gt; The improvement in the business climate for industry, after the difficulties of 2015, will remain gradual. The slowdown in consumption will drag down services.</li> <li>&gt; Despite the upward trend in unit labour costs (low productivity, wage increases), inflation is (and will remain) contained by margin erosion.</li> </ul>	<ul style="list-style-type: none"> <li>&gt; Growth potential stunted for the foreseeable future ("secular stagnation")</li> <li>&gt; Excessive rise in the dollar (including after the Brexit)</li> <li>&gt; Political risk (presidential election)</li> </ul>
<b>BRAZIL</b>	<ul style="list-style-type: none"> <li>&gt; The new Government announced new fiscal-discipline measures in order to restore investor confidence. However, the economic (deep recession) and political (the ongoing corruption inquiries continue to incriminate new politicians) backdrop could make it difficult to implement these measures.</li> <li>&gt; The new BCB Governor is looking at a monetary easing policy in order to stimulate growth. However, between the Brexit and the uncertainty surrounding US monetary policy, there is a risk that the dollar will appreciate. As such, the real could depreciate once more and increase inflationary pressures if the BCB decides to leave its rates unchanged.</li> </ul>	<ul style="list-style-type: none"> <li>&gt; Less budget consolidation than necessary</li> <li>&gt; Resurgence of inflationary pressure</li> <li>&gt; Debt monetisation</li> </ul>
<b>EUROPE</b>		
<b>EUROZONE</b>	<p><b>Continued recovery, but at a slower pace, in light of the shock of uncertainty triggered by the Brexit.</b></p> <ul style="list-style-type: none"> <li>&gt; The recovery will continue, and will be underpinned by domestic demand. The pace and quality of the recovery improved in early 2016.</li> <li>&gt; The uncertainty triggered by the Brexit will cause a dip in late 2016 and early 2017, due to 1) a sharp slowdown in the United Kingdom that will have a knock-on effect on exports to the UK, and 2) negative impacts on confidence that will drag down investment. We have reduced our 2017 GDP growth forecast from 1.5% to 1.2%.</li> <li>&gt; The upcoming packed political calendar in the eurozone (Italian referendum in October, elections in the Netherlands, France and Germany in 2017) may also encourage companies to defer their investments.</li> </ul>	<ul style="list-style-type: none"> <li>&gt; Political risk (Brexit, refugee crisis, rise of anti-establishment parties)</li> <li>&gt; Contagion of the emerging world's economic and/or financial hardships</li> <li>&gt; Increasing deflationary pressures</li> </ul>
<b>UNITED KINGDOM</b>	<p><b>Sharp slowdown due to political uncertainty.</b></p> <ul style="list-style-type: none"> <li>&gt; The lack of visibility over how the UK's exit from the EU will be managed and the future framework for relations with Europe will be a severe weight on the economy. We are anticipating a short-lived recession in H2 (most likely in Q4) followed by a rebound in H1 2017, but at a slower pace.</li> <li>&gt; Private investment (corporate, real estate) and consumption will be hit hard. They will suffer from the impact of rising inflation due to the depreciation of the pound. We have reduced our 2017 GDP growth forecast from 2% to 0.2%.</li> </ul>	<ul style="list-style-type: none"> <li>&gt; Shock of uncertainty related to the Brexit</li> <li>&gt; Public and foreign deficits still very high</li> </ul>
<b>ASIA</b>		
<b>CHINA</b>	<p><b>China: a growth engine for the global economy in 2016 and 2017</b></p> <ul style="list-style-type: none"> <li>&gt; We believe that the economic bottoming in China is sustainable but a U-shape recovery is unlikely.</li> <li>&gt; This is in light of the lagging effects of aggressive policy easing in 2015, and potential aggressive monetary and fiscal easing in the pipeline and ahead.</li> <li>&gt; Chinese RMB remains an uncertainty for global capital markets in 2016.</li> <li>&gt; Brexit puts China in a sweet spot where the PBoC can ease when it wants to, and can take this opportunity to depreciate the RMB.</li> </ul>	<ul style="list-style-type: none"> <li>&gt; Growth engine for the global economy in 2016 and 2017</li> <li>&gt; RMB remains an uncertainty for global capital markets</li> </ul>
<b>INDIA</b>	<p><b>India: a steady growth engine for Asia in 2016</b></p> <ul style="list-style-type: none"> <li>&gt; India is positioned on steady growth improvement.</li> <li>&gt; Inflation moderation is sustainable in 2016 given a high probability of good monsoon.</li> <li>&gt; After Rajan announced that he would leave the RBI on 4 September 2016, we think that the next RBI governor will adopt an easing bias to support growth. The RBI has to remain accommodative longer than market expected, and ease bigger than market expected.</li> </ul>	<ul style="list-style-type: none"> <li>&gt; Indian growth is positioned to pick up</li> <li>&gt; Inflation moderation is sustainable</li> </ul>
<b>JAPAN</b>	<p><b>Continued growth at a slow pace.</b></p> <ul style="list-style-type: none"> <li>&gt; Consumption is being underpinned by the improved labour market (rise in the participation rate) and the easing of inflation. The budget stimulus plan and the lower corporate tax rate are also supporting factors.</li> <li>&gt; However, the pick-up in wages remains very slow and the rising yen is hampering exports.</li> <li>&gt; Despite the fact that PM Abe will maintain a very large majority in Parliament following July's elections, it is unlikely that he will be able to overcome the resistance to the anticipated structural reforms.</li> </ul>	<ul style="list-style-type: none"> <li>&gt; Exposure to Chinese slowdown</li> <li>&gt; Rising yen</li> </ul>

## Macroeconomic and financial forecasts

### MACROECONOMIC OUTLOOK

- United States:** end of the cycle. Profits have reached their peak but the labour market remains robust and tensions on wages are beginning to appear. Industry is stabilising after a soft patch in late 2015, however, services, which until now have been supporting the recovery thanks to robust household consumption, are showing some signs of slowing down.
- Japan** a slow exit from deflation. Households must adapt to higher prices. Wage increases are the key to a lasting recovery, however, the slowdown in China and the rising yen are dragging down business confidence.
- Eurozone:** the recovery is continuing and is gaining in quality thanks to a rebound in business investment. However, the significant uncertainty associated with the political crisis triggered by the UK referendum will cause a dip in late 2016 and early 2017.
- Brazil:** although the growth carryover for 2016 is -2.5%, we prefer maintaining for the moment our growth forecast at -2.5% for 2016 and -0.5% for 2017, which goes against the consensus viewpoint for a deep recession this year (-3.7%) and a return to positive growth in 2017. We believe that inflation could decline under the weight of the deteriorating labour market and limit the contraction in private consumption. Moreover, in light of the economic and political situation, public spending cuts could end up being less than those announced.
- Russia:** in Russia, second-quarter economic figures were fairly encouraging. Furthermore, first-quarter GDP turned out to not be as bad as in the fourth quarter of 2015 and exceeded expectations (GDP growth of -1.2% year-on-year vs. -3.8% in Q4 2015). As such, we have revised our growth forecasts and now anticipate a less severe recession in 2016 (-0.7% vs. -1.8% previously) and a more substantial rebound in 2017 (+1% vs. +0.5% previously).

Annual averages (%)	Real GDP growth. %			Inflation (CPI. yoy. %)		
	2015	2016	2017	2015	2016	2017
<b>US</b>	<b>2.4</b>	<b>2.0</b>	<b>1.8</b>	<b>0.1</b>	<b>1.5</b>	<b>2.0</b>
<b>Japan</b>	<b>0.5</b>	<b>0.6</b>	<b>0.8</b>	<b>0.8</b>	<b>0.7</b>	<b>1.7</b>
<b>Eurozone</b>	<b>1.6</b>	<b>1.5</b>	<b>1.2</b>	<b>0.0</b>	<b>0.4</b>	<b>1.1</b>
Germany	1.5	1.6	1.3	0.1	0.5	1.4
France	1.1	1.4	1.1	0.1	0.4	1.1
Italy	0.8	1.1	1.1	0.1	0.2	1.4
Spain	3.2	2.6	1.3	-0.5	0.0	1.1
<b>UK</b>	<b>2.2</b>	<b>1.1</b>	<b>0.2</b>	<b>0.1</b>	<b>0.8</b>	<b>1.6</b>
<b>Brazil</b>	<b>-3.8</b>	<b>-2.5</b>	<b>-0.5</b>	<b>9.0</b>	<b>6.8</b>	<b>6.0</b>
<b>Russia</b>	<b>-3.7</b>	<b>-0.7</b>	<b>1.0</b>	<b>15.5</b>	<b>10.0</b>	<b>8.5</b>
<b>India</b>	<b>7.3</b>	<b>7.5</b>	<b>7.6</b>	<b>5.2</b>	<b>5.4</b>	<b>5.2</b>
<b>Indonesia</b>	<b>4.8</b>	<b>5.0</b>	<b>5.1</b>	<b>6.4</b>	<b>4.5</b>	<b>4.5</b>
<b>China</b>	<b>6.9</b>	<b>6.7</b>	<b>6.5</b>	<b>1.4</b>	<b>1.2</b>	<b>1.2</b>
<b>Turkey</b>	<b>3.8</b>	<b>2.6</b>	<b>3.0</b>	<b>7.7</b>	<b>7.5</b>	<b>7.0</b>
<b>Developed countries</b>	<b>1.9</b>	<b>1.7</b>	<b>1.4</b>	<b>0.2</b>	<b>1.0</b>	<b>1.6</b>
<b>Emerging countries</b>	<b>4.1</b>	<b>4.1</b>	<b>4.4</b>	<b>4.0</b>	<b>4.2</b>	<b>3.7</b>
<b>World</b>	<b>3.1</b>	<b>3.1</b>	<b>3.1</b>	<b>2.4</b>	<b>2.8</b>	<b>2.8</b>

Source: Amundi Research

### KEY INTEREST RATE OUTLOOK

- FED:** the worsening of the macro-financial situation will prompt the Fed to be more cautious. This is now unlikely that the Fed would hike in 2016.
- ECB:** the sharp fall of German yields is complicating the ECB's QE implementation. In particular, the big question is the abandon of capital key rule for sovereign bonds purchases.
- BoJ:** given the mediocre economic backdrop and the sharp yen appreciation, it is now very likely that the BoJ will boost its QE.
- BoE:** it is now certain that the BoE will cut rates on July 14. The use of unconventional monetary policy tools is likely.

	01/07/2016	Amundi + 6m.	Consensus Q4 2016	Amundi + 12m.	Consensus Q2 2017
<b>US</b>	0.50	0.50	0.70	0.75	1.05
<b>Eurozone</b>	0.00	0.00	0.00	0.00	0.00
<b>Japan</b>	-0.10	-0.10	-0.10	-0.10	-0.10
<b>UK</b>	0.50	0.00	0.35	0.00	0.55

### LONG RATE OUTLOOK

- United States:** the high macrofinancial uncertainty, the perspective of a very limited fed funds tightening cycle, the reinvestment of maturing US Treasuries by the Fed and the portfolio reallocation of European investors are not in favor of a significant rise of long-term yields. The yield curve will continue to flatten.
- Eurozone:** the downward pressure on long-term yields will persist for a while. A change of the ECB's QE structure is likely to benefit to peripheral bonds.
- United Kingdom:** the markets will without doubt ask the question of a QE or negative rates from the BoE. As a consequence, there is still room for a fall of UK yields.
- Japan:** the introduction of negative rates by the BoJ induced a sharp decline of bond yields. Along with QQE, this policy will maintain long term yields very low for a prolonged period.

2 Y. Bond yield					
	01/07/2016	Amundi + 6m.	Consensus Q4 2016	Amundi + 12m.	Consensus Q2 2017
<b>US</b>	0.56	0.60/0.80	0.69	0.60/0.80	0.81
<b>Germany</b>	-0.64	-0.60/-0.40	-0.64	-0.60/-0.40	-0.65
<b>Japan</b>	-0.33	-0.40/-0.20	-0.34	-0.40/-0.20	-0.32
<b>UK</b>	0.14	-0.20/0.00	0.12	-0.20/0.00	0.20

10Y. Bond yield					
	01/07/2016	Amundi + 6m.	Consensus Q4 2016	Amundi + 12m.	Consensus Q2 2017
<b>US</b>	1.41	1.60/1.80	1.50	1.60/1.80	1.58
<b>Germany</b>	-0.13	0.00/0.20	-0.09	0.00/0.20	-0.05
<b>Japan</b>	-0.25	-0.20/0.00	-0.25	-0.20/0.00	-0.22
<b>UK</b>	0.81	0.60/0.80	0.87	0.60/0.80	0.95

### CURRENCY OUTLOOK

- EUR:** we expect a relative stability of the euro in effective terms in the coming months.
- USD:** the US dollar appreciated after the Brexit vote but there is no catalyst for a sustained appreciation. The USD would decline in the case where the Fed would give up its tightening cycle.
- JPY:** being long yen is now rather risky as a reaction of Japanese authorities is now very likely.
- GBP:** the pound dropped dramatically after the Brexit vote. Although it is now undervalued according to numerous models, it may drop further in the coming weeks.

	06/07/2016	Amundi + 6m.	Consensus Q4 2016	Amundi + 12m.	Consensus Q2 2017
<b>EUR/USD</b>	1.10	1.10	1.08	1.10	1.08
<b>USD/JPY</b>	101	110.00	105.00	110.00	107.00
<b>EUR/GBP</b>	0.86	0.90	0.84	0.90	0.83
<b>EUR/CHF</b>	1.08	1.10	1.08	1.10	1.10
<b>EUR/NOK</b>	9.38	9.10	9.19	9.00	9.18
<b>EUR/SEK</b>	9.48	9.10	9.22	8.90	9.10
<b>USD/CAD</b>	1.30	1.30	1.32	1.30	1.30
<b>AUD/USD</b>	0.75	0.75	0.71	0.75	0.72
<b>NZD/USD</b>	0.71	0.70	0.67	0.70	0.66



## 1 Brexit: towards a recession in the United Kingdom and a slowdown of growth in the Eurozone

DIDIER BOROWSKI, *Research, Strategy and Analysis*

**The Brexit vote is a huge source of uncertainty:** uncertainty over the future of trade relations between the UK and the EU and therefore, potentially, on the future location of certain industries; political uncertainty (which prime minister? For which policy and which negotiating model?), and further uncertainty over the country's unity (possible referendum on independence in Scotland). One thing is sure - these uncertainties will not be resolved any time soon. **Heads of State and the government were clear at the summit of 29-30 June:** no negotiation - even informal - can begin until the British government invokes Article 50 (which ratifies the procedure for a country exiting the EU). In the best case, the uncertainty on this topic will continue until 16 September (the date of the next informal summit of the EU-27), one week after the Conservative party elects a leader to succeed David Cameron as prime minister. Nonetheless, the UK is making clearer commitments on the Brexit vote. All of the candidates for Prime Minister are now in agreement on the fact that Article 50 must be invoked but probably not before late-2016 or early-2017.

**This shock of uncertainty may send the British economy into recession.** Since the UK will remain a full member of the EU for at least two more years, it isn't the trade channel that will affect the British economy. On the other hand, the total lack of visibility will push economic actors to postpone their purchasing plans or decisions. Thus, between now and the end of the year we are likely to see:

- **A downturn in business investment and a freeze on hiring.** The primary determinant in business investment is anticipated demand (which will drop). Thus investment plans will be postponed, whenever possible. The same is true for hiring, which will, by all appearances, come to a halt.
- **A rise in household savings.** Consumers, fearing for their jobs, tend to build up precautionary savings. The household savings rate, which has dropped significantly over the past few years (from 9% in 2012 to 4.2% in 2015), may surge back up (remind that it was at 9% on average between 1996 and 2011). Not to mention that inflation caused by the pound's depreciation will weigh on their purchasing power (households import a great deal of the goods they consume).
- **A depreciation in real estate.** There is a housing bubble, especially in London. The decline in demand will drive prices down. The good news is that this will return the least-mortgaged households to solvency. But at the same time, it will generate a "negative wealth effect" that will weigh heavily on consumption.

**However, there's no reason to become deeply pessimistic.** The British economy has always been flexible and resilient against shocks. Moreover, a large part of the goods consumed are imported, so the impact on GDP should ultimately be less than the impact on domestic demand, especially since exports should benefit from the pound's depreciation (-15.6% against the US dollar vs the average of H2 2015). Finally, and above all, economic policy is going to get very accommodative: beyond the Bank of England, which will quickly lower its interest rates, there is also fiscal policy to consider. Once in place, the new PM will probably adopt an expansionist policy (tax cuts). Against this backdrop, we anticipate a short-lived recession (two quarters of contraction in GDP, Q3 and Q4 2016), then a rebound in growth as of H1 2017 (but at a slower pace than before the Brexit vote). **That's why we are revising our growth forecast (annual averages) from 1.8% to 1.1% in 2016 and from 2.0% to 0.2% in 2017 (+1.3% yoy, Q4 2017 vs. Q4 2016).**

**The recovery in the Eurozone will continue, but at a slower pace.** The shock of uncertainty affects the UK most of all. Remember that the euro was (before the Brexit) enjoying good cyclical momentum, driven by domestic demand. From

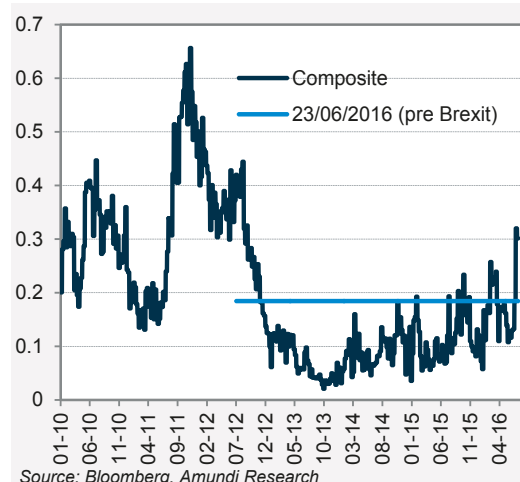
### The essential

**The Brexit vote is a huge source of uncertainty: uncertainty over the future of trade relations between the UK and the EU, political uncertainty and further uncertainty over the country's unity. This shock of uncertainty may send the British economy into recession.**

The total lack of visibility will push economic actors to postpone their purchasing plans or decisions. However, in the absence of significant monetary and financial tightening, the impact on the Eurozone will be less severe. We are revising our growth forecast down. The ball is in the court of the Heads of State or Governments. Only they are capable (1) of avoiding stalemate, (2) of maintaining the EU's cohesion and (3) of taking initiatives to jumpstart the "European project". In the short term, they are going to have to reach an agreement on recapitalising the Italian banking sector in order to contain the financial stress.

“ Article 50 will likely be triggered in late-2016 or early-2017 ”

### 1 ECB's Systemic Financial Stress Indicator



a fundamental standpoint, there is no reason to change the scenario. Indeed, at this stage, monetary and financial conditions remain highly accommodative. The current episode has nothing in common with the recession triggered by Lehman's collapse, or with the one precipitated by the sovereign debt crisis (credit crunch). **The economic impact on the Eurozone passes, primarily through trade exposure (goods and services), from the EU to the UK.** Exports from the Eurozone to the UK are automatically going to drop due to the decline in domestic demand and the pound's depreciation. But the portion of exports to the UK is a mere 4% of the Eurozone's GDP, which is not enough to derail the recovery. However, it would be unwise to consider that trade is the only transmission channel through which the Brexit can impact the economy. Business surveys are likely to deteriorate and domestic demand may slow (see box). **At the end of the day, we are revising our growth forecast down by 0.3 pp, from 1.5% to 1.2% in 2017. All things considered, the Brexit would trigger a slowdown in growth, but it should not challenge improvement on the jobs front.**

> **Uncertainty and growth: what do we know?**

**Uncertainty is a hard concept to measure. There are several types of uncertainty with multiple dimensions. We will confine ourselves here to two of them: political uncertainty and financial uncertainty.**

– Political uncertainty is defined on a rather rudimentary basis by the frequency with which some key words or expressions are used in the financial press<sup>1</sup>. Political uncertainty has spiked since the Brexit vote (see charts).

– To grasp financial uncertainty we propose to use the ECB's stress index. We keep an especially close eye on this indicator, as it is observable by everyone and it is a factor that can steer the ECB's words and deeds. Since Brexit, this index has moved to levels not seen since the sovereign debt crisis<sup>2</sup> (see charts).

– In a seminal work on the link between uncertainty and investment decisions, Ben Bernanke<sup>3</sup> put forth the argument that the impact can be explained by the high cost of reversibility of an investment (vs. the cost of waiting for new information). A company carries through on its investment plans when its expected return surpasses its cost of capital. But uncertainty shuffles the cards and it may be more reasonable to postpone investment decisions. For the same reasons, companies may slow their hiring (the more rigid the labour market, the more pronounced this phenomenon is, because the costs of reversibility are high) and households may defer their purchases of durable goods. Many empirical studies have confirmed that uncertainty puts a drag on domestic demand.

On the corporate front, Brandon Julio and Youngsuk Yook<sup>4</sup> studied investments in 48 countries between 1980 and 2005, from a microeconomic perspective. They found that elections disrupt investment cycles considerably. They found in particular that in the year prior to an election, companies tend to lower their spending by about 5% compared to non-election years. The impact is even greater when the election outcome is uncertain. During these episodes, companies hold more cash, which suggests that they are not giving up their investment projects forever but are buying time until there is greater visibility. If the regulatory or tax environment is uncertain, the impact of election cycles is

<sup>1</sup> For the United Kingdom (see accompanying chart), the index reflects the portion of articles in the Financial Times and the Times of London dealing with the economy (i.e., containing the terms "economy" or "economic"), politics ("taxes", "policies", "regulation", "spending", "deficits", "budget" or "Bank of England") and uncertainty ("uncertain" or "uncertainty").

<sup>2</sup> It is probably not by chance that it was when this stress indicator spiked the ECB let the rumour to circulate that it was planning to buy securities prorated to countries' debt, rather than to their ECB capital key. Prorating purchases to debt would benefit Italy (and France) more than Germany. Germany would be even more amenable to that as it is the first victim of the current capital key, which is helping to send German yields into negative territory. A change in the capital key would stabilise Italy in the event the banking crisis worsens.

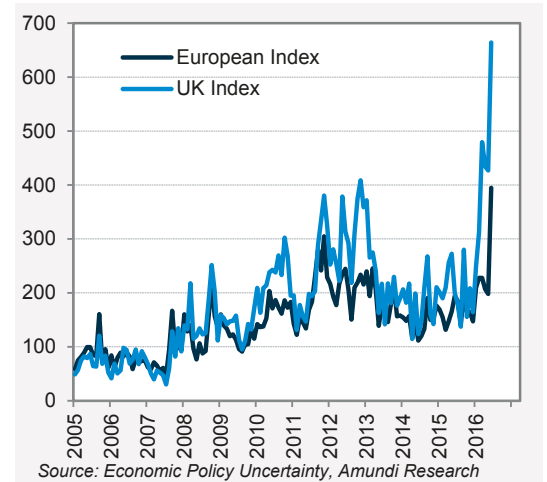
<sup>3</sup> Ben Bernanke. "Irreversibility, uncertainty and cyclical investment", Quarterly Journal of Economics, Vol.98, no. 1 (1983).

<sup>4</sup> Political uncertainty and corporate investment cycles", B. Julio and Y. Yook, the Journal of Finance (2012)

“ The UK recession will be short-lived ”

“ This is a political crisis above all ”

2 Political uncertainty indexes



even greater. The more unstable the government, the greater the impact on investment, particularly in sectors that are potentially vulnerable to economic policy. That's why it has also been found that tight elections with high stakes have greater impact than elections with predictable outcomes. Once uncertainty recedes, investment rebounds (so the negative impact on investment is temporary in most cases).

In a way, the pre-referendum weakness in the UK economy may be due to the high uncertainty in the months prior to the vote. After the vote, political uncertainty spiked in the UK, as well as in Europe in general, as seen in shifts in political uncertainty indices (see chart).

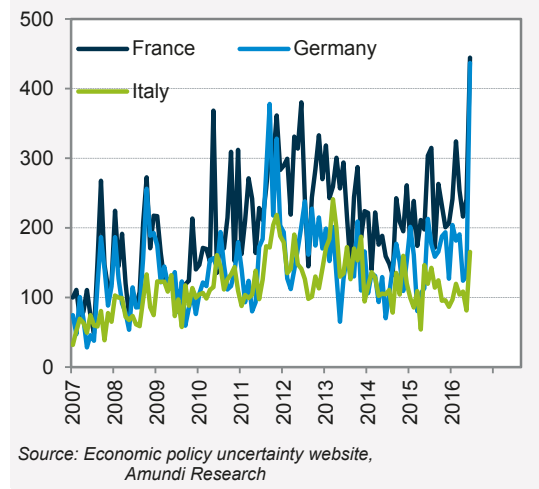
The weakness in Italian banks, combined with an especially busy political calendar (an informal EU-27 Brexit summit in Bratislava on 16 September, and a referendum on the constitution in Italy in early October are adding to the uncertainty. Not to mention the holding of new presidential elections in Austria, on 2 October, and a referendum in Hungary on "European immigration quotas" (scheduled on the same date), which may exacerbate centrifugal forces within the EU.

**The slowdown in domestic demand caused by this climate of uncertainty is nonetheless impossible to calibrate ex-ante** (there are too many unknowns). At this point, we have nonetheless seen that credit conditions have not become any tougher, which is reassuring for economic momentum. Financial conditions remain accommodative, despite the prevailing financial stress. Interest rates are still low in all countries; financial establishments have unlimited access to liquidity; and the euro has stabilised in terms of effective exchange rate. Against this backdrop, we expect the impact of uncertainty on final demand to remain contained and, in this case, far below that seen during the sovereign debt crisis.

Admittedly, the risks are on the downside. That's why: (1) central banks are ready to do more; and (2) long-term interest rates continue to decline (with a flight to "safe havens").

**Nonetheless, risks are very clearly tilted to the downside.** The political crisis in the UK may cause a political crisis throughout Europe. Then the confidence shock would spread through the entire Eurozone: consumption and investment would slow down significantly, growth could fall below 1%, and unemployment could climb. **A shock of this nature would increase deflationary pressure,** force the ECB to adopt more monetary easing and governments to implement fiscal stimulus. The ball is in the camp of the Heads of State or Governments. Only they are capable (1) to prevent stalemate, (2) to maintain the EU's cohesion and (3) to take initiatives to jumpstart the "European project". In the short term, they are going to have to reach an agreement on recapitalising the Italian banking sector in order to contain the financial stress.

3 **Political uncertainty indexes**



“The Brexit is a drag on Eurozone growth”



## 2 The renminbi, the new cornerstone of emerging currencies

BASTIEN DRUT, *Strategy and Economic Research*  
ROBERTA FORTES, *Strategy and Economic Research*

Since the summer of 2015, the USD/RMB exchange rate has taken on unprecedented importance on the financial markets. The renminbi's episodes of accelerated depreciation against the US dollar in August 2015 and January 2016 were the source of major market turbulence. They caused concerns over the Chinese economy and, by extension, the emerging markets in general, to reappear, which had a negative impact on risky assets (at least temporarily) and slowed down the Fed's rate tightening cycle. The renminbi also took on a new status on the currency markets, with trends in the currency now a determining factor for other emerging currencies.

The successive quantitative easing (QE) programmes initiated by the Fed, the BoJ and the ECB have led to a significant depreciation in effective terms of the dollar, yen and euro which, in the post-Great Recession years, meant a substantial appreciation in the renminbi, the only important currency in the international system whose central bank had not adopted a QE policy.

In May 2016, China's real effective exchange rate was 30% above its average value in 2008, however, in the eurozone's and Japan's cases, it was 14% and 11% lower respectively, and 13% higher in the United States. While the question of the renminbi being undervalued was relevant before the Great Recession, today there is no doubt that the currency is overvalued, in particular in light of the Chinese economy's current and future challenges. The question of how the Chinese authorities should manage the yuan's overvaluation is one of the most important for the markets over the coming years.

The renminbi reached a very high level in 2015, particularly due to the dollar's renewed appreciation, which catapulted the need for monetary reforms to the forefront. On 11 August 2015, the PBoC announced that market forces would play a greater role in fixing the renminbi's exchange rate. In two days, the USD/RMB exchange rate rose 2.8%. Two weeks after the renminbi was admitted into the IMF's special drawing right currency basket (on 30 November 2015), the PBoC announced that it would no longer measure the renminbi against the US dollar alone, but rather against a basket of thirteen currencies (often referred to as the CFETS basket).

This decision was made as part of a strategy to gradually unpeg the renminbi from the dollar.

Over the last twenty years, China has taken on an increasingly important position in emerging-market trade relations, one that has now become essential. For example, China accounts for 18% of Malaysia's exports and 20% of Brazil's exports, compared to 8% and 3% respectively in the mid-1990s. This clearly has major repercussions for exchange rate valuations. Whereas the renminbi had little impact on the valuation of the Malaysian ringgit or the Brazilian real 20 years ago, the opposite is true today. Fluctuations in the renminbi have a major impact now.

The best way to convince ourselves of this is undoubtedly to look at the changes in the weighting of the major currencies (USD, EUR, JPY, RMB) in the effective exchange rates calculated for emerging currencies by the BIS. Charts A, B et C represent the changes in these weightings over three separate periods of time: 1993-1995, 2002-2004 and 2011-2013.

### The essential

Until recently, the increase in China's economic weighting manifested on the currency markets primarily through the impact the country's economy had on commodity prices. The trend in the renminbi itself had relatively little impact on the other currencies because the renminbi was extremely stable and closely pegged to the dollar. That said, recent monetary reforms changed the game in a big way.

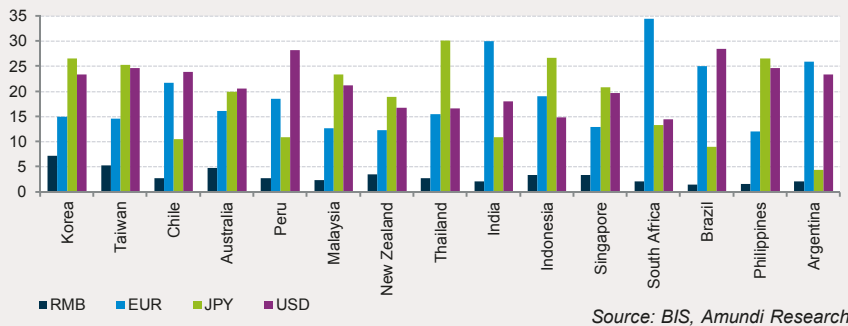
The new Chinese currency regime led the currency markets into a new paradigm. The slightest fluctuations in the renminbi have a greater impact on trends in emerging market currencies than on developed currencies.



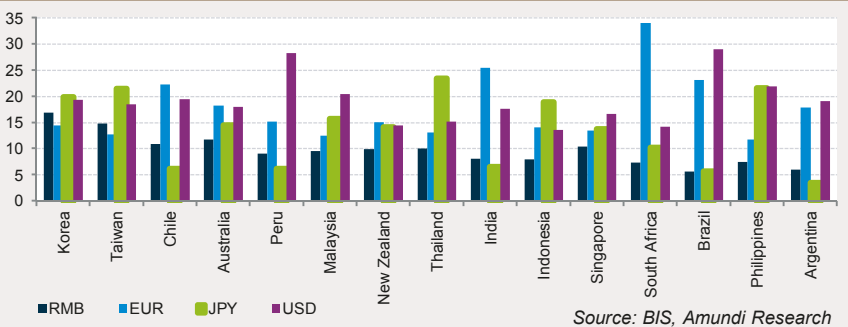
The renminbi took on a new status on the currency markets, with trends in the currency now a determining factor for other emerging currencies



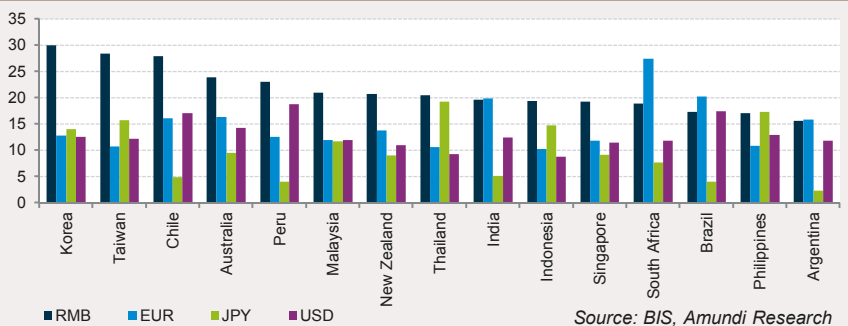
**A - Weights of the key currencies in effective exchange rates' baskets (1993-1995)**



**B- Weights of the key currencies in effective exchange rates' baskets (2002-2004)**



**C- Weights of the key currencies in effective exchange rates' baskets (2011-2013)**

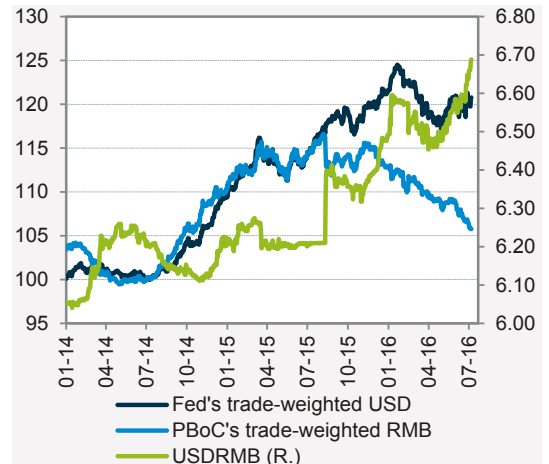


The renminbi is now the currency that has the highest weighting when calculating the effective exchange rates for South Korea, Taiwan, Chile, Australia, Peru, Malaysia, New Zealand, Thailand, Indonesia and Singapore, as well as ... the eurozone, the United States and Japan. Note that for Asian countries, the weight of EUR and USD has the same order of magnitude, often below the weight of the RMB (except in the case of Philippines).

Until recently, the increase in China's economic weighting manifested on the currency markets primarily through the impact the country's economy had on commodity prices. The trend in the renminbi itself had relatively little impact on the other currencies because the renminbi was extremely stable and closely pegged to the US dollar. That said, recent monetary reforms changed the game in a big way.

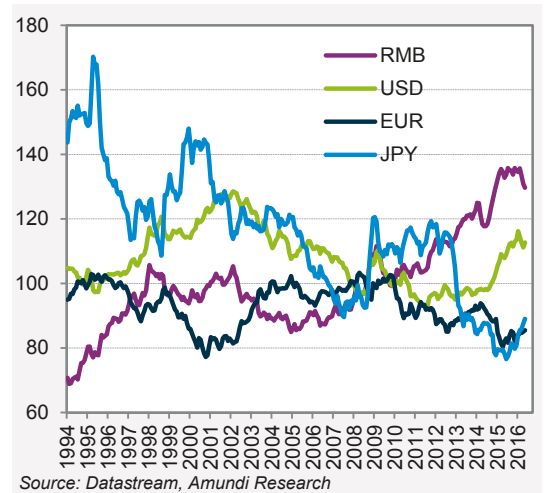
The new Chinese currency regime led the currency markets into a new paradigm. It is clear that fluctuations in the USD/RMB exchange rate have played an increasingly significant role in emerging currency trends. One of the ways to assess the impact of the renminbi on other countries' currencies is to estimate regressions using Frankel & Wei's method ("Yen bloc or dollar bloc? Exchange rate policies of the East Asian Economies", 1994).

**1 USD and RMB effective exchange rates vs USD/RMB parity**



Over the last twenty years, China has taken on an increasingly important position in emerging-market trade relations, one that has now become essential.”

**2 Real effective exchange rate (100 = 2008 average)**



These regressions relate exchange rate movements of currency X against a reference currency (the Swiss franc for example) to movements of four major currencies (USD, EUR, RMB, JPY) against this same reference:

$$\Delta \ln \left( \frac{X_t}{CHF_t} \right) = \alpha + p_1 * \Delta \ln \left( \frac{USD_t}{CHF_t} \right) + p_2 * \Delta \ln \left( \frac{RMB_t}{CHF_t} \right) + p_3 * \Delta \ln \left( \frac{EUR_t}{CHF_t} \right) + p_4 * \Delta \ln \left( \frac{JPY_t}{CHF_t} \right)$$

The dominant reference currency is defined as the currency with the highest positive coefficient in the regression. We estimated "Frankel-Wei" regressions for two periods: period A from July 2014 to the end of July 2015, and period B from the beginning of August 2015 to the end of June 2016. Period A covers the first phase of the dollar's appreciation, during which the Chinese authorities allowed the renminbi to appreciate with the dollar. Period B covers the new Chinese currency regime with the unpegging of the renminbi from the dollar and the tracking using the CFETS basket. The results are shown in the following table.



Recent monetary reforms changed the game in a big way



"Frankel-Wei" regressions

	Period A: July 2014 - July 2015						Period B: August 2015 - June 2016					
	USD	CNY	EUR	JPY	R <sup>2</sup>	Dominant reference currency	USD	CNY	EUR	JPY	R <sup>2</sup>	Dominant reference currency
INR	0.42	0.54	-0.03	0.04	0.95	CNY	<b>0.4 **</b>	<b>0.57 ***</b>	-0.1	<b>-0.16 **</b>	0.81	CNY
IDR	0.15	<b>0.78 *</b>	0.03	-0.02	0.93	CNY	0.15	<b>0.75 **</b>	-0.24	-0.27	0.42	CNY
MYR	0.47	0.29	0.13	0.07	0.9	USD	-0.32	<b>1.34 ***</b>	-0.2	<b>-0.58 ***</b>	0.49	CNY
SGD	0.29	0.23	<b>0.21 ***</b>	<b>0.2 ***</b>	0.98	USD	-0.08	<b>0.71 ***</b>	0.13	<b>-0.16 *</b>	0.64	CNY
HKD	<b>0.97 ***</b>	0.02	<b>0.01 **</b>	0	1	USD	<b>0.96 ***</b>	<b>0.05 **</b>	-0.02	-0.01	1	USD
KRW	0.53	0.13	0.1	0.16	0.9	USD	0.32	0.55	-0.06	<b>-0.27 *</b>	0.45	CNY
PHP	<b>1.42 ***</b>	-0.38	-0.08	0.02	0.97	USD	<b>0.59 ***</b>	<b>0.35 **</b>	-0.12	<b>-0.17 ***</b>	0.84	USD
THB	0.39	0.5	-0.05	<b>0.13 *</b>	0.96	CNY	<b>0.5 **</b>	<b>0.38 *</b>	-0.07	-0.12	0.69	USD
TWD	<b>0.51 *</b>	0.38	0.02	0.03	0.98	USD	<b>0.4 **</b>	<b>0.57 ***</b>	-0.14	<b>-0.13 *</b>	0.81	CNY
BRL	-0.78	1.03	0.2	0.46	0.57	CNY	0.27	0.43	-0.07	<b>-0.48 *</b>	0.14	CNY
CLP	-0.2	0.87	<b>0.23 **</b>	0.16	0.88	CNY	0.13	<b>0.72 **</b>	0.13	-0.15	0.45	CNY
COP	-0.42	0.91	0.26	0.06	0.57	CNY	-0.43	<b>1.32 **</b>	0.25	-0.36	0.26	CNY
MXN	-0.76	<b>1.49 **</b>	0.08	0.15	0.83	CNY	-0.14	<b>1.32 ***</b>	0.21	<b>-0.39 *</b>	0.5	CNY
PEN	<b>0.52 **</b>	0.41	0.06	0.02	0.98	USD	<b>0.47 **</b>	<b>0.5 **</b>	0.11	-0.08	0.74	CNY
CZK	<b>0.56 **</b>	<b>-0.54 **</b>	<b>0.94 ***</b>	-0.01	0.98	EUR	-0.03	0.03	<b>0.99 ***</b>	-0.01	0.97	EUR
HUF	0.08	-0.06	<b>0.96 ***</b>	0.08	0.92	EUR	-0.31	0.23	<b>1.19 ***</b>	0	0.53	EUR
PLN	-0.01	0.04	<b>0.92 ***</b>	0.13	0.93	EUR	-0.21	0.29	<b>0.88 ***</b>	<b>-0.16 *</b>	0.42	EUR
RON	0.16	-0.07	<b>1.01 ***</b>	-0.07	0.97	EUR	-0.12	0.12	<b>0.95 ***</b>	0.04	0.83	EUR
RUB	<b>-5.13 **</b>	<b>5.81 **</b>	0.01	0.58	0.46	CNY	0.15	0.95	-0.83	-0.45	0.25	CNY
TRY	-0.95	<b>1.58 *</b>	<b>0.29 *</b>	0.11	0.78	CNY	0.04	<b>0.88 **</b>	-0.3	-0.29	0.4	CNY
ILS	<b>1.29 **</b>	-0.84	<b>0.33 ***</b>	0.18	0.9	USD	<b>0.49 *</b>	0.15	<b>0.58 ***</b>	<b>-0.18 *</b>	0.58	EUR
ZAR	-1.01	1.46	0.21	<b>0.34 *</b>	0.78	CNY	-0.87	<b>1.72 **</b>	0.41	-0.48	0.22	CNY

\*\*\* 1% significance level, \*\* 5% significance level, \* 10% significance level

We can observe some important changes evolving the different currencies between the two periods. Our estimates suggest that the renminbi became the dominant reference currency for a higher number of emerging currencies. Specifically, for the 26 EMEs currencies assessed, the number of emerging currencies for which the renminbi is the dominant reference currency went from 10 on the period A to 14 on the period B, whereas the number of emerging currencies for which the US dollar is the dominant reference currency went from 8 on the period A to 3 on the period B. The euro is the dominant referent



currency for the other currencies while the yen is not the dominant referent for any currency.

**Besides, the predictive power of the “Frankel-Wei” regressions has declined for all of the currencies considered.** It was very high during the period A and has declined sharply afterwards. This is an indication that EM currencies followed far less clearly the four big currencies than before. Note also that the coefficient of the renminbi increased for 17 currencies was the one that presented the largest number of increases in the co-movements with EMEs currencies in period B (17 out of 26 cases, which represents 65% of the total). The coefficient of the euro, the yen and the US dollar fell in the majority of cases.

**It is particularly interesting to see that in period B the renminbi has gained ground against the US dollar as the main currency of influence for Asian economies,** suggesting it has possibly supplanted the US dollar as the most important reference currency in this region. Specifically, the coefficients of the renminbi in the regressions either increased markedly or stabilized. The renminbi has also significantly increased its role in the Latam foreign exchange markets. Both results can possibly be explained by the important trade ties between China and its Asian neighbors and the strong commodity-trade link between China and Latam economies. Specifically, some works emphasizes that the weight on renminbi is plausibly a function of the commercial link but also the financial links that China has with many economies and that are as much regional as global (see, i.e., Eichengreen and Lombardi, 2015).

**Specifically regarding Asia, it is important to note that our results contradict a common wisdom of the existence of a “Dollar bloc” in this region** and seem to corroborate the view that the currencies in this area might try to follow a more trade effective orientation (see, i.e., Ho, Ma and McCauley, 2005). However, the USD remains the dominant reference currency for the Phillipian peso and the Thailand bath and the USD coefficient remains high and significant for the Indian rupee.

**Concerning Latin America, our results are particularly intriguing due to the almost inexistence of a dominance effect of the US dollar in this region.** Due to geographic, historic and even political reasons, Latin America is considered as a natural zone of influence of the dollar (more on this topic, see i.e. Eichengreen and Lombardi, 2015). However, our results suggest that the US dollar has apparently lost its “backyard” to the renminbi. Note that the predictive power of these regressions fell dramatically for Latam currencies, suggesting that idiosyncratic factors played a higher role during the period: for instance, the BRL has suffered a strong influence of the Brazilian political crisis (for the BRL, the R<sup>2</sup> fell from 0.57 to 0.14). This explanation could be extended to the case of ZAR, South Africa having also suffered from major political instability.

All in all, while there are still many discussions in the literature about the potential of the RMB to potentially emerge and stand as a global reference currency (Eichengreen and Lombardi, 2015 pointed out this as an extremely difficult thing to foresee), **our results clearly suggest that the RMB has risen as a major reference currency to EMEs and its influence seems to go well beyond its neighborhood area, findings that go in the same direction of the recent literature on the topic.**

## Conclusion

The new Chinese currency regime introduced in August 2015 led the currency markets into a new paradigm. The slightest fluctuations in the renminbi have a definitely greater impact on trends in emerging market currencies than in the past. This highlights how important is the evolution of the USD/ RMB parity for emerging currencies and thus how important will be the next Chinese monetary reforms: a disorderly depreciation of the renminbi would be very negative for emerging currencies.



Our results contradict a common wisdom of the existence of a “Dollar bloc” in Asia



The RMB has risen as a major reference currency to EMEs and its influence seems to go well beyond its neighborhood area



### 3 China Property Market: Bubble or no bubble?

MO JI, *Strategy and Economic Research*

The outlook for the Chinese property market, especially for 2016 and 2017, is becoming increasingly unclear to global investors. Property inventory destocking is indeed happening, with spill-over effects from Tier-1 cities to Tier-2/3/4 cities (no bubble?), and with rising land prices, especially from Tier-1/2 cities and also with potential spill-over effects to Tier-3/4 cities (bigger bubble?). What view should we as investors take?

#### Why focus on the Chinese property market?

There is only one pillar industry in China and that is property. It is important in determining the direction of Chinese economic growth, given that the property sector is linked to over two hundred sectors, both downstream and upstream. Hence, there is one simple outcome in the event of a hard landing in Chinese property, and that is that the Chinese economy, and therefore the global economy, will experience a hard landing. How healthy the Chinese property sector is, fundamentally shapes the outlook for the Chinese economy with knock-on-effects on the global economy. The property sector's impact on the Chinese economy is real, in contrast to the equity, bond, or commodity futures markets, or FX market corrections, none of which have direct impact on the real economy.

#### What are the major debates?

- 1. Bubble?** Arguments that there is a Chinese property bubble are based on: (1) little affordability; (2) low rental; (3) lots of construction over the years, already with zombie homes, etc.
- 2. No bubble?** Arguments that there is not a bubble are generally based on: (1) officially, income has been rising faster than housing prices (of course, housing prices may be understated, and income may have risen fast among the rich, so there is an issue of inequality); and (2) the lack of leverage, in that the loan-to-value ratio is low, household debt is limited, and bank loans to the property sector are limited (direct loans, in any case).
- 3. Structural bubble?** The arguments would be: (1) most household wealth is held in deposits, which earn low rates (lower than the housing price increase), and this incentivizes people to buy property; (2) no property tax; (3) local governments are pushing up land prices; (4) lots of construction already; and (5) construction as a share of per capita GDP is rising constantly.
- 4. Property supply?** The term "supply" is really hard to quantify, especially under the pre-sales system, in which developers can fasten construction to meet pre-sales criteria or, on the contrary, slow it down and reduce "supply". The government can also reduce supply by halting all issuance of pre-sales consents. Hence the supply is rather dynamic.
- 5. Property demand?** Similarly, the market normally uses the transaction volume to quantify demand, which is rather dynamic, as well, in our view. On a more fundamental basis, actual demand synthesized by urbanization, marriage, housing upgrades, etc. can help us reach a healthier supply-demand balance. Of course, in practice, this is rather difficult to quantify, as well.
- 6. Property equilibrium?** The supply and demand balance in the housing market hinges on the amount of "excess vacancies", defined as the number of vacant housing units above and beyond the level warranted in normal circumstances. Even in normal times, when there is little imbalance between housing supply and demand, vacant homes exist because of second homes and household turnovers. Excess vacancies are an important measure of housing oversupply. However, excess vacancies are difficult to pin down, as well.

#### The essential

**How healthy the Chinese property sector is, fundamentally shapes the outlook for the Chinese and world economy.**

With significant property inventory destocking over the past year, the bubble is diminishing to a larger extent. However, Chinese land prices are also rising significantly in some cities and regions, and we believe ever rising land prices could lead to a potential property bubble.



Bubble or no bubble?



Structural bubble?



The above six arguments have long been there, and given lack of data, it is very hard to make judgments. We have to change the angles of our analysis.

For the long term, in our October 2015 Cross Asset Monthly, we made the point clearly that the new-born population is closely correlated with new housing demand years later. From the experience of Japan, a 41% reduction in the number of births from 1948 to 1961 resulted in a 29% decline in floor space of new starts from 1973 to 1983; similarly, a 40% reduction in the number of births from 1973 to 1989 resulted in a 46% decline in floor space of new starts from 1994 to 2012. As for China, the number of births fell 38% from 1987 to 2003, and the coming years will likely see a major decline in floor space of new starts. Hence the real Chinese GDP growth will decline, given that the property sector is its pillar industry.

### What are the facts?

Here, we will focus, however, on Chinese residential property and the near term (2016 and 2017) for investment relevance.

#### 1. Prices

- In Chinese Tier-1 cities (Beijing, Shanghai, Shenzhen, and Guangzhou) property prices had a huge run from the start of 2015 to June 2016, with property prices on average increasing by 167% in Shenzhen (this is beyond everyone's expectation, and mainly due to annual supply restrictions) and by 49% in Beijing, whereas Shanghai and Guangzhou were almost unchanged.
- In Tier-2 cities, i.e. provincial cities, such as Chengdu, the capital city of Sichuan province, prices rose around 45% within a space of eighteen months; in contrast, the capital city of Hainan province, Haikou, experienced a steady price correction totalling 23%.
- In Tier-3 cities, Dongguan, Guangdong province, was up around 39% over the same period. Wenzhou's prices have now stabilised after steep corrections, which is a positive signal for Eastern China stabilization after its correction.
- China has over 600 cities. Even Tier-5 cities have populations of no less than 1 million. Price movements within and between tiers are different, given the large number of cities and locations, housing scarcity, housing supply restrictions, home purchasing restriction policies (yes or no), land prices, and so on.
- It is clear that the sharp property prices rise in Beijing, Shenzhen, Chengdu, and Dongguan are not what the Chinese government wants to achieve (it wants property prices stable within a narrow range). Hence, we have seen tightening policies after the sharp property price rises in March/April.

“Shenzhen property prices up 167% within one and half years!”

“Shanghai inventory months to clear at 5.5 now!”

#### PRICE, per square meters in RMB

		4-Jan-15	19-juin-16	% change
<b>Tier 1</b>	Beijing	21,498	31,951	49%
	Shanghai	22,881	22,346	-2%
	Shenzhen	25,539	68,149	167%
	Guangzhou	15,003	16,263	8%
<b>Tier 2</b>	Hangzhou	22,188	24,187	9%
	Chengdu	7,130	10,373	45%
	Haikou	11,876	9,114	-23%
<b>Tier 3</b>	Wenzhou	14,376	14,629	2%
	Dongguan	10,176	14,126	39%

Source: Soufun, Wind, CEIC, and Amundi Research

**2. Volume**

- Months to clear inventory is one good indicator of a bubble (generally, if this is more than 20 months) and how big the bubble is (generally, if the months to clear are above 30 or 40).
- As for Tier-1 cities, Beijing's months to clear inventory was down from 32.4 months (Mar 2015, peak level), to 7.8 months (Dec 2015, trough level), indicating a clearance of 24.6 months of inventory within 9 months, which is significant reduction in inventory in that short period of time. From March 2015 to March 2016 within a year's time, Shanghai/Shenzhen cleared 17/17.9 months of inventory, which is significant as well.
- As for Tier-3 cities for example, Ningbo/Xiamen in Eastern China, cleared 39.3/33.2 months of inventory within a year's time, which is a very significant reduction.
- We also need to look at the current status of inventory months to clear. As of mid-June 2016, there were severe shortages in terms of inventory months for cities such as Shanghai (5.5 months), Hangzhou (2.4 months), and Nanjing (2.2 months).
- The direct implication from inventory clearance is that developers' cash flow is getting much stronger, hence with more cash available for further property investment.

“300 cities' land prices rose 57% in the first five months of the year!”

**Inventory, months to clear, Jan 2015 to June 2016**

		Peak	Peak month	Trough	Trough month	juin-16
<b>Tier 1</b>	Beijing	32.4	mar-15	7.8	dec-15	13.5
	Shanghai	20.2	mar-15	3.2	mar-16	5.5
	Shenzhen	22.9	mar-15	5.0	mar-16	14.2
	Guangzhou	28.4	mar-15	6.6	may-16	7.7
<b>Tier 2</b>	Hangzhou	15.6	mar-15	2.1	apr-16	2.4
	Nanjing	22.4	mar-15	1.9	june-16	2.2
	Fuzhou	29.9	june-15	6.7	apr-16	10.3
<b>Tier 3</b>	Ningbo	46.1	mar-15	6.8	apr-16	8.8
	Xiamen	37.5	mar-15	4.3	may-16	9.2

Source: Soufun, Wind, CEIC, and Amundi Research

**3. FAI**

- Strong property inventory clearance generated strong cash flow for developers, hence strong pickup in property investment. Given the mounting property inventories, which peaked around last March, property investment has been pretty sluggish, and was in negative growth for five months in a row from September last year. Property investment truly rebounded from this February (2%), March (8%), April (11%) and May (8%), after the strong inventory clearance that had been almost completed around March this year.
- What worries the market is the sustainability of property investment going into the second half of 2016 and also into 2017. For regions and cities with inventory shortages, we believe property investment will hold at mid- to high-single-digit growth at least to the end of 2016. In China as a whole, there is a large chance that overall property investment can hold at around mid-single-digit growth, which hasn't been expected by the market since the end of last year.

“Property policy has to remain overall accommodative!”

**4. Mortgage loans**

- Housing mortgage loans have been growing very steadily quarter by quarter, at around 6% to 7%, with an acceleration in the first quarter of 2016 to 7.2% qoq growth. The major driver has probably been the declining mortgage rate, at only 4.17% now vs. more than 5.5% previously.



- Chinese housing mortgage loans as a percentage of GDP are on a clear rising path, from 19% of GDP in the first quarter of 2015 to 23% in the first quarter of 2016.

## 5. Land sales

- "Land kings" reappear with strong property inventory destocking and robust pickups in property investment. The value of the first five months' land sales in Hangzhou rose by more than 286% from last year, and Suzhou is even at 1533% in comparison to the first five months of 2015. The 300-city average figure for China is 68%, and land prices are becoming much more expansive than before. As for Key Tier-2 cities, land sales amazingly grew by more than 163%.
- What does this phenomenon reflect? For certain cities with strong housing demand but scarce land supply, "land kings" are unavoidable consequences. This will push the residential property prices even higher.
- Local government's dependence on land revenue is still high, given long overdue property taxes.
- **We believe the overall Chinese property market bubble is due to ever-rising land prices, and when land prices are much higher than potential rates of return, that is where the bubble has to burst. Hence, close monitoring of land prices is key to judging potential risks in the Chinese property market.**
- Shanghai as a typical example where land supply is decreasing but land prices are rising significantly, and the final sold price is even 42% higher than the launched price for the first five months of 2016. This is obviously not sustainable!

### China Residential Land Sales

5M16, yoy	Land Sales	Land Volume (GFA)	Land Price	% of price sold over launched
Beijing	-45%	-65%	56%	-9%
Shanghai	17%	-54%	152%	42%
Hangzhou	286%	72%	124%	50%
Nanjing	576%	168%	152%	71%
Suzhou	1533%	106%	693%	64%
300 Cities	68%	7%	57%	35%
Tier-1 Cities	-18%	-44%	48%	15%
Key Tier-2 Cities	163%	7%	145%	23%

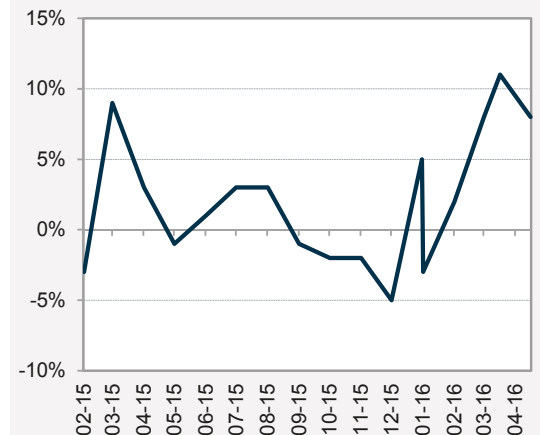
Source: Soufun, Wind, CEIC, and Amundi Research

### What is the property policy outlook?

As far as we understand, the role of the property sector as the single pillar industry in China hasn't changed. Hence, in order to achieve the GDP target (6.5-7% in 2016, and 6.5% per annum by 2020), the overall policy towards the property market will be biased on the easing side.

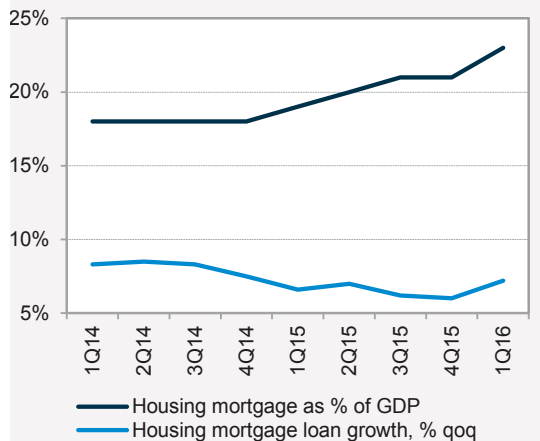
The Chinese government strives to strike a balance between stable property/land prices and relatively low inventory levels. Hence, whenever there are property/land price hikes, the Chinese government will have to come up with some tightening measures to mitigate the impact. The government pays more attention to inventory, and if mounting inventory is in sight, easing measures will certainly be announced soon thereafter. From May till mid-June we had more property easing measures than tightening measures, and even the inventory level on average is already relatively low.

### 1 Residential Property Investment, yoy %



Source: Soufun, Wind, CEIC, Amundi Research

### 2 Chinese Housing Mortgage Loan



Source: Chinese Housing Mortgage Loan, Amundi Research



The role of the property sector as the single pillar industry in China hasn't changed



**Conclusion**

How healthy the Chinese property sector is, fundamentally shapes the outlook for the Chinese. With significant property inventory destocking over the past year, the bubble is diminishing to a larger extent. However, Chinese land prices are also rising significantly in some cities and regions, and we believe ever-rising land prices could lead to a potential property bubble. And when land prices are much higher than potential rates of return, that is when the bubble has to burst.

**Property Easing Measures**

- 6-May-16**      HPF loan approval duration expected to be reduced from 15 days to 10 days: The government released a notice on improving provisions on personal loans in the housing provident fund, aiming to streamline the procedures of HPF loan applications and optimizing business procedures. According to the notice, the main supplementary application documents will be proof of identity (e.g., copies of ID card) and proof of home purchase. For second homes, an intended borrower and his/her spouse, as well as the seller can submit relevant materials to selected bank branches, which can pass on initial feedback to the applicants. For other types of homes, the applicant can also choose to submit applications through agencies. The duration of approval of applications is expected to be reduced from 15 days to 10 days as a result.
- 9-May-16**      MOHURD will support the leasing market in China in six ways: Mr. Lu Kehua, Vice Minister of Housing and Urban-Rural Development, said in a meeting that the leasing market has yet to be developed and also lacks standardization and property rules and regulations. He said the ministry will support the leasing market in six ways: i) nurturing supply groups; ii) encouraging leasing consumption; iii) improving the public leasing system; iv) supporting the construction of leasing properties; v) enhancing policy support; and vi) enhancing monitoring of the leasing market.
- 10-May-16**      Citizens in Nanjing are encouraged to use HPF for rent payments: the HPF Management Center of Nanjing has issued a notice stating that the application period for withdrawal of HPF for rent payments will be extended. Applications can be made from June to December each year. Previously, such applications could only be made in June and December. The monthly quota for rental payment is RMB 900 / RMB 1,800 for individuals / couples.
- 10-May-16**      Henan lowers farmers' entry barrier to housing mortgage: MOHURD of Henan province and the Finance Office of the province and Agricultural Bank (601288.SS; 1288.HK) jointly announced a new plan to assist farmers in applying for mortgage loans to purchase residential units. Some features of the plan are: a lower benchmark score for housing mortgage applications; simplified proof of income; flexibility in choosing quarterly, semi-annual or annual repayments; zero penalties for early repayment; accepting payment guarantees issued under local government-controlled financing guarantees aims to improve credit quality.
- 13-May-16**      Beijing to provide public rental housing to the newly employed: MOHURD of Beijing issued a notice that the ministry has allocated 490 public rental units in three projects for those who are newly employed and are aged between 18 and 35. The applicants have to be employed and not own any property units in the city. Non-local citizens are also eligible if they meet the criteria for home purchasing in Beijing.
- 16-May-16**      Zibo launches pilot scheme on subsidized rentals of government-subleased units: Media reported that since the end of 2015, a new mode of subsidising public housing has arisen amid the many problems encountered in building affordable housing. In Zibo, Shandong Province, the local government rents houses of GFA not greater than 100sqm and "subleases" the units to qualified citizens at a lower rent. The difference in the rent is subsidized by the local government. Officials from the relevant housing authorities claim that the pilot scheme could improve utilization of idle houses in the city and alleviate the funding and time pressures for the construction of affordable housing.
- 19-May-16**      Chengdu HPF Management Committee announced that, starting from June 6, the term of personal HPF loan will increase from 20 years to 30 years. For any family of two persons or above the single lump sum that can be borrowed will be RMB 700,000. Also, the ratio of maximum loan to HPF contribution will be lifted to 30x, and any citizen whose individual contribution is less than RMB 10,000 will not be subject to such a ratio and will be eligible for HPF loan of RMB 300,000.
- 20-May-16**      The first batch of co-ownership housing to be launched in Nanjing: Nanjing Price Bureau published a notice on the price of housing units available from the conversion of affordable housing. In particular, housing units of four selected affordable housing projects will be converted into the first batch of co-owned private units in the city and sold at ASP of approximately RMB 9,952 psqm, compared with average ASP for commodity residential units of approximately RMB 19,000 psqm. Qualified buyers will be able to select houses starting from 1 July 2016.



- 24-May-16** PBOC allows RMB30trn capital entering the bond market: PBOC issued a document on 20 May that eligible institutional investors including HPF, pension funds, charity funds and more wealth management products are allowed to enter the interbank market. PBOC will be following the standard criteria and procedures to issue the notice for approved of applications from those eligible investors, and such notice will be valid for three months. Industry participants commented that the arrangement by the PBOC is smoothing the application process and encouraging commitments in the bond market. Media reported that the total scale of the mentioned funds is approximately RMB30trn.
- 2-Jun-16** Hunan aims to reduce land supply in cities with high inventories: The government of Hunan Province has issued a statement on enhancing the aggregate use of land resources. Cities with high stock levels will be required to reduce the scale of land use plans and land supply. In addition, the government may suspend land supply in cities with inventory periods of three years or more. The government, however, encourages long-term leasing, the practice of renting a land site before purchasing it in the future, and other flexible land supply arrangements that can help reduce land cost for enterprises. (Hexun)
- 3-Jun-16** State Council releases new policies for rental market: On 3 June the State Council published an opinion to speed up development of the residential rental market. Measures include: permitting the conversion of commercial properties to residential housing units; 1.5% VAT to be applied to rental income from properties owned by individuals will; VAT will be exempted for individuals with rental income of less than RMB 30K per month until end-2017; 6% VAT on real estate agencies providing residential rental brokerage services; 5% VAT will be applied to rental income from properties acquired before the VAT pilot scheme was launched.
- 10-Jun-16** Dalian announces relaxing policies on destocking: On 8 June the government of Dalian issued a document detailing new policies to develop the city's real estate market. The policies, targeting at destocking for the city, include: i) to complete all shanty town redevelopment works in 2-3 years; ii) to provide talents, leaders or the like with a maximum of RMB3mn of subsidy for house purchase; iii) to provide a subsidy of RMB100 psqm for home upgrades under certain conditions; iv) to remove HPRs imposed on the four districts of the city as well as the high-tech development zone; and v) to remove restrictions regarding the maximum number of commodity residential units foreigners can buy.
- 15-Jun-16** New loosening measures in Shanxi to tackle inventory problems: The government of Shanxi Province released a document on 13 June detailing 11 measures to help destocking in the real estate sector. Key measures are: to lower the down-payment ratio for loans of first-time purchase of commodity residential housing units to 20%; to lower such ratio for home upgrade purchases to 30%; to lower deeds tax for property transactions by 1-2%; to relax conditions for workers from rural areas to transfer their hukou to the current work location; to encourage modification of unsold commodity properties for other purposes such as e-commerce business and incubators for technology enterprises.

## Property Tightening Measures

- 5-May-16** Land supply will be strictly controlled for Beijing-Tianjin Hebei development: MLR and NDRC issued a land use plan for the development of the Beijing-Tianjin-Hebei region in 2015-2020. The plan has mentioned that, for regions that need to reduce the land supply, basically there will be no new construction land supply and some of the existing construction land will be changed for environmental purpose. And some regions will be maintained a stable scale of total land use where large scale of construction is not favourable. For regions that need to increase land supply, new land supply will be controlled with the focus on social infrastructures.
- 5-May-16** Beijing MOHURD and the local government of Tongzhou District jointly issued a notice regarding tightening measures on property market: eligible homebuyers for apartment units for commercial / residential use have to fulfil one of the following criteria: i) families or individuals who are with local hukou but without owning any property units; ii) families who own one property units in the city; iii) non-local families who own no property units in the city and have contributed to the social insurance and with tax payment proofs for five consecutive years. The notice also mentioned that newly constructed commercial and office properties can only be sold to companies or organizations, and the same measures will also apply to the reselling of such properties.
- 18-May-16** The MLR of Suzhou Municipality announced that for some of the land parcels to be auctioned on or after May 23, price caps will be imposed, and the ministry has the right to void a land sale should the final price exceed the cap (circuit breaking). People with knowledge of the matter revealed that the highest priority for the ministry right now is to avoid further cases of excessive land prices and consequently to cool down developers' quest for land in the city, ahead of potential HPRs. (Guandian)
- 27-May-16** The government of Nanjing issued a notice saying that tightening measures for Nanjing will be launched, to control land and property prices. The measures include: i) capping the total land premium for auctions. If bidders raise the bidding price over the limit, the land auction will be terminated and the bidding price will become invalid. ii) Over the 45% threshold of the premium to the asking price, developers will be bidding on the area of social housing to be provided in the project. Moreover, the cost of projects will be strictly monitored by the pricing bureau; the portion of land cost that is over a 45% premium to the asking price cannot be included as part of the development cost, and hence, this will not be included in the consideration for price setting.

**4 The labour market in the eurozone is definitely improving, and a little less slowly at that**

TRISTAN PERRIER, *Strategy and Economic Research*

After the double-dip recession in recent years and the recovery that started in the beginning of 2013, in early 2016 the eurozone's GDP returned to a level close to its pre-crisis peak in Q1 2008. However, the same does not hold true for the major labour market indicators, which, despite unquestionable signs of improvement, remain far removed from the levels they were at eight years ago.

**There has been a substantial recovery of the labour market, but it is lagging significantly behind GDP.** Starting with the most commonly observed labour market indicators, on a eurozone-wide scale, **full employment** has only erased just over **two-thirds** of the maximum loss seen during the crisis years (generally between Q1 2008 and mid-2013), while the **unemployment rate and the total number of unemployed** have declined by just over **one-third** (see Chart 1 and the table at the end of this article).<sup>1</sup>

A slightly closer examination of jobs lost and created demonstrates that these initial indicators, as poor as they may be, still paint an **overly positive picture of the real situation**, primarily for the following reasons:

**1.1/Most of the improvement is due to an increase in part-time employment.** Therefore, the ground that remains to be recovered is far greater if measured in terms of hours worked than in number of jobs (Chart 1). Whether we consider hours worked or full-time employment only (graph 2), barely one-third of the loss has been recovered today. Likewise, adding people working part-time because they could not find full-time jobs to the numbers of unemployed, the reduction in this hence "augmented" unemployment rate (20.6% in 2015 after a peak of 21.1% in 2013) is considerably less impressive than that of the "headline" unemployment rate - see table at the end of the article.

**2.2/The labour market is one area where divergences between eurozone member states are very stark.** In fact, eurozone figures are being driven higher by the numbers in Germany, where the major labour market variables were only slightly (and briefly) impacted by the crisis and which, in reality, experienced a very different employment cycle (its unemployment rate was among the highest in the eurozone in the early 2000s). Apart from Germany, the eurozone has not recovered half the jobs lost during the crisis years (particularly if we only include full-time jobs, see Chart 2).

**As a result, the eurozone labour market still seems quite distant from a situation that would generate widespread wage pressures. It is true that** the unemployment rate (10.1% at the end of May) is no longer so far from official estimates of the level that is supposed to trigger an acceleration of inflation (NAIRU<sup>2</sup> reported by the OECD at 9.4% and NAWRU<sup>3</sup> reported by Eurostat at 9.7%). However, in light of the factors mentioned above (the pool made up of people working part-time for economic reasons, other indicators that remain very depressed in some countries), it seems likely that the NAIRU will be revised downward (as has occurred in the United States several times in recent years), without, however, excluding pockets of localised (especially in Germany, although the gradual entry of refugees into the labour market could be a moderating factor of wage growth) or sector wage pressures.

**However, despite this very incomplete repair, the recovery has been reflected in the labour market in increasingly tangible ways since 2015.** Because employment and unemployment rates typically lag behind GDP, they usually react slowly during the initial phase of a recovery (and this all the more

<sup>1</sup> The differences among these degrees of recovery are mostly due to the fact that the labour force continued to increase during this period.

<sup>2</sup> Non-accelerating inflation rate of unemployment.

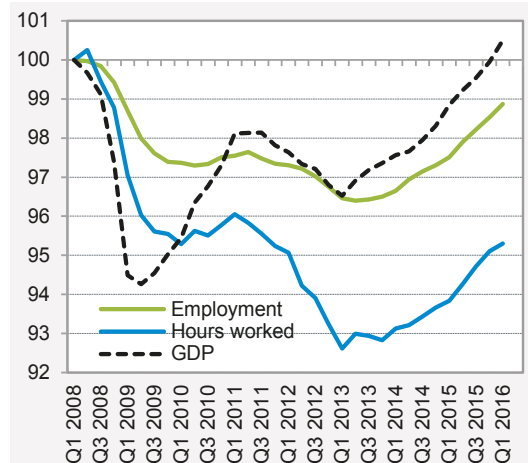
<sup>3</sup> Non accelerating wage rate of unemployment.

**The essential**

**Unlike GDP, key labour market indicators in the eurozone still have a long way to go to return to their pre-crisis levels. Total employment volume, much as its improvement remains limited, still paints an overly optimistic picture of the situation, which is in fact considerably worse once we factor in indicators such as full-time employment rates and divergences between Member States.**

Nonetheless, the positive spill-over of the economic recovery to the labour market is taking place, with clear signs of acceleration over recent quarters. This trend is one of the reasons why we think the recovery in the eurozone is now strong enough to withstand the forthcoming major political uncertainties. On the other hand, a situation where the labour market could, on a eurozone scale, generate genuine inflationary pressures is still a dim and distant prospect.

**1 Eurozone, employment and hours worked vs GDP, volume, basis 100 in Q1 2008**



Source: Eurostat, Amundi Research

**Unemployment has fallen and is no longer so far from the NAIRU**

when the recovery itself is slow). As the new European growth cycle is now in its fourth year, some signs of acceleration have started to show in several major indicators, including those reflecting the most deleterious and lasting consequences of the crisis.

**Firstly, the unemployment rate itself has begun falling more rapidly over the last 12 months** (-0.9pp between May 2015 and May 2016, after -0.6pp between May 2014 and May 2015) while the GDP growth rate was not accelerating to the same extent. Looking at the last projections published before the Brexit shock, we note that although the ECB had considerably lowered its 2016 and 2017 growth forecasts relatively to those published 12 months ago (from 1.9% and 2.0% in June 2015 to 1.6% and 1.7% in June 2016), it had not simultaneously increased its unemployment rate projections (down slightly, on the contrary, from 10% to 9.9%).

**What's more, we note that 2015 marked the beginning of a positive re-correlation among Member States:** the unemployment rate fell in Italy, which was not the case in 2014 (the Italian economy took a very long time to return to growth), and even in France starting in late 2015 (a country where the relative demographic strength means that a higher pace of job creation is required, relatively to neighbouring countries, for the unemployment rate to decline).

**Furthermore, among the indicators reflecting the lasting effects of the crisis, the long term and very long term unemployment rates,** which declined only very modestly in 2014, **fell significantly in 2015** after having doubled (or more) with the onset of the crisis (see Chart 4). While it is wise to be cautious with these figures (many very long-term unemployed workers have probably dropped out of the labour force), labour market reforms implemented in recent years probably played a part. In particular, we note that France, which implemented only modest labour reforms, is hardly touched by this improvement.

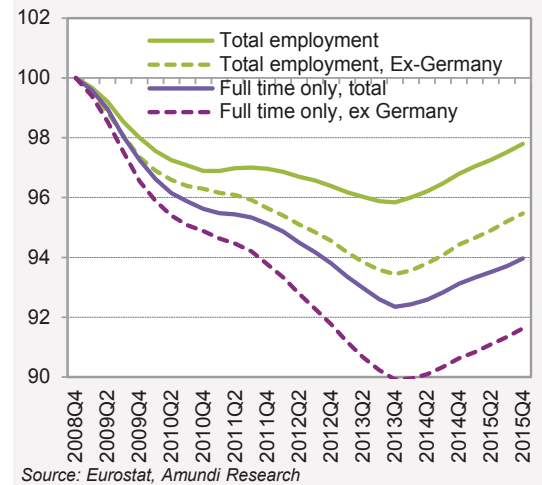
**Lastly, the percentage of NEETs** (Youth Not in Employment, Education or Training) **fell faster in 2015 than in previous years.** We also saw a few signs of a falling NEET in Italy, where this indicator is particularly high (casting youth into a situation that in many respects is more worrisome than that prevailing in Spain, where the youth unemployment rate is significantly higher but because youth participation in the labour force is higher - see Chart 5). It is a particularly important factor in an environment where the challenges posed by "anti-system" political forces, fuelled largely by the disappointment of people who are not seeing the positive impacts of the economic recovery, figure prominently among the main factors of uncertainty weighing on economic confidence.

**Therefore, overall, improvement in the labour market is mixed.** If you base the comparison on the situation prevailing prior to the crisis, much more time is certainly needed to return to the levels that existed eight years ago. Regarding some indicators (in particular full-time employment), it is not even certain that pre-crisis levels can be reached during the current cycle given the structural changes in the labour market and demographic trends.

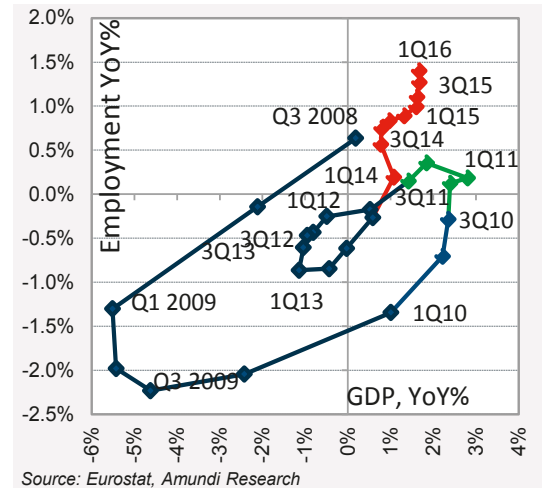
Nonetheless, a careful examination of the trends in the last few quarters shows that a clearly positive dynamic has taken hold and is accelerating slightly. This is a fundamental consideration since, in the next few months, the eurozone economy will have to cope with the challenge posed by *Brexit* (through exports, confidence and, possibly, financial channels). With positive effects on consumer spending, this less depressed labour market looks more and more capable of fuelling a self-perpetuating domestic demand trend that is likely to be healthier and more sustainable than the temporary factors that supported the recovery until recently (a lower euro and lower oil prices). **It is** (alongside the recent improvement in corporate investment in Germany and France) **among the main reasons why we think that the economic recovery in the eurozone may be slowed but not interrupted by the overt political crisis with the United Kingdom.**

On the other hand, turning to the outlook for inflation, the improvement in the labour market remains, for now, a factor that is more likely to limit deflationary pressures rather than fuelling genuinely inflationary pressures, which still remain a distant prospect. Wage developments (Chart 6) in fact show the lack

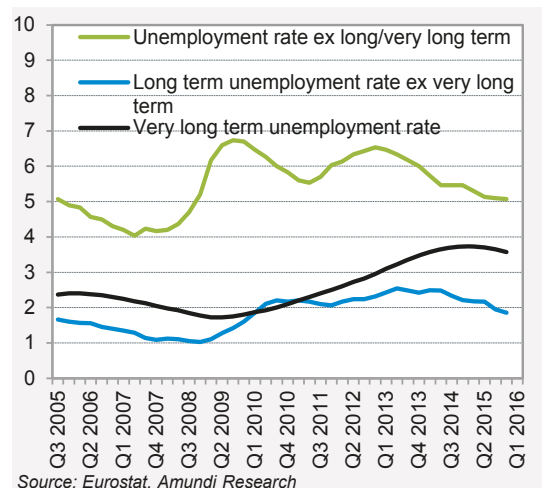
**2 Eurozone, total employment and full-time employment, volume, 4QMA, basis 100 in Q4 2008**



**3 Eurozone, YoY real GDP and employment growth**



**4 Eurozone, short/medium term, long term, very long term unemployment rate, %**



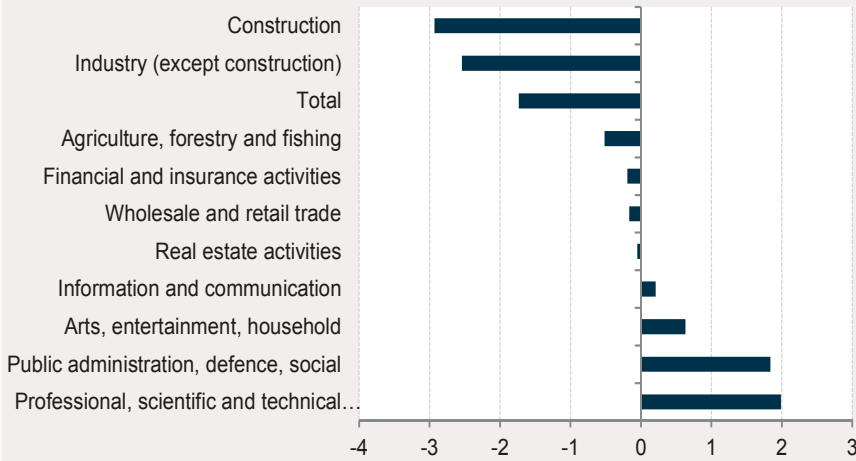
of progress in this direction. Germany could be an exception, which may raise significant challenges for both monetary and general policy, but on balance it is unlikely that improvement in the labour market will be a factor likely to prompt the ECB to scale back its unconventional monetary support measures.

	Pre-crisis best	Crisis worst	Last
<b>Employment, volume, 000s</b>	154,360	148,797	152,624
<b>Unemployment rate, %</b>	7.2	12.1	10.1
<b>Unemployed, volume, 000s</b>	11,393	19,333	16,267
<b>Hours worked, volume, million</b>	62,730	57,950	59,630
<b>Full-time jobs, volume, 000s</b>	118,597	109,527	111,446
<b>Part time jobs, volume, 000s</b>	28,159	/	32,069
<b>Participation rate, % of labour force</b>	71.3	/	72.4
<b>Employment rate, % of 15-64 y/o pop.</b>	65.9	63.4	64.7
<b>Long term unemployment rate, %</b>	2.8	6.1	5.4
<b>Very long term unemployment rate, %</b>	1.7	3.7	3.6
<b>Unemployment rate, 16-24 y/o, %</b>	15.1	24.6	21
<b>"Augmented" unemployment rate*</b>	18.3	21.1	20.6

\*Unemployed + people working part time because they could not find a full time job

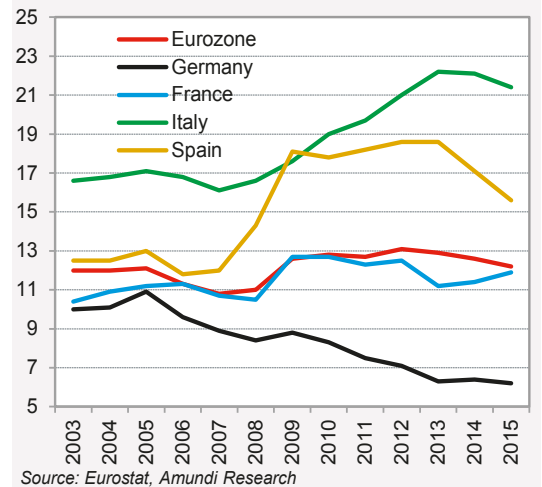
Source: Eurostat, figures unadjusted for seasonal variations have been smoothed with a 4 quarter moving average

**Employment by sector, variation from Q1 2008 to Q1 2016**



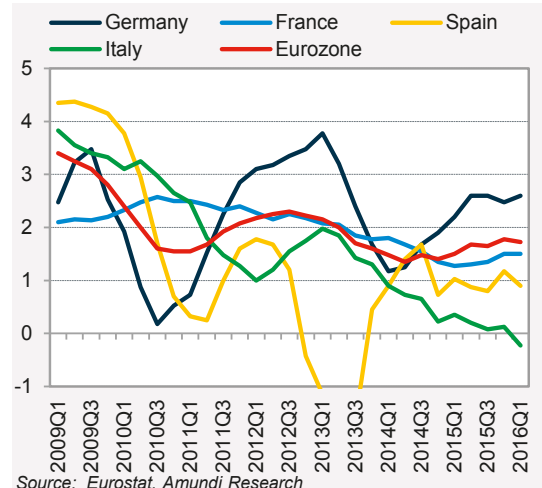
Source: Eurostat, Amundi Research

**5 NEEETs (Not in Education, Employment or Training), % of 16-24 y/o pop.**



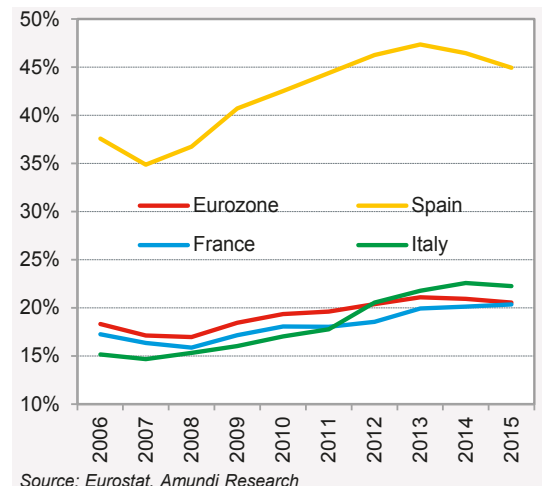
Source: Eurostat, Amundi Research

**6 Nominal hourly wages, YoY%, 4QMA**



Source: Eurostat, Amundi Research

**7 "Augmented" unempl. rate (unemployment and part time for economic reasons)**



Source: Eurostat, Amundi Research

**5 Will earnings growth return next year?**

IBRA WANE, *Strategy and Economic Research*

The equity markets were caught wrong-footed by Brexit. Some valuations dropped sharply but that is seldom reason enough to buy. As we return to fundamentals, in this article we will review the credibility of consensus earnings prospects. We will focus on some sector biases which are highly instructive.

**The surprise victory of Brexit caught the markets off guard.** After much hesitation they suddenly rallied a few days before the election. From 16 to 23 June – i.e., from the murder of Jo Cox to the referendum – the MSCI EMU and UK both gained about 7%, plus another 5% by sterling. Many investors were ultimately caught wrong-footed by the outcome of the referendum, triggering a **sudden drop in risky assets and a retreat into “safe havens”**, like sovereign yields, the yen, the Swiss franc, the dollar and gold.

On Monday 27 June, at the peak of the crisis, the MSCI EMU and UK were down, respectively, by 11% and 6% vs. 23 June, and sterling had lost more than 11%. Since then, the equity markets have clawed back some of their losses. One week later, on 4 July, the MSCI EMU was down “just” 5% compared to 23 June, the MSCI Europe was almost unchanged (-2%), and the MSCI UK was even up +3% (see chart 1).

**So the situation appears to be stabilising, but things are not so simple in reality.** While US and emerging markets indices held up very well, Europe markets diverged. Switzerland and northern Europe fared well, but the euro zone was hit hard, especially on its periphery. The performance of the MSCI UK is misleading, as sterling is still down 10% vs. the USD. As a reflection of the persistent anxiety, “safe havens” are still trading strongly. Sector performances are also highly revealing of the prevailing malaise. For example, the MSCI Europe limited decline (-2%) masks the huge divergence between energy (+7%) and defensives (+4%) on the one hand, and cyclicals (-4%) and financials (-13% in Europe and up to -25% in Italy) on the other hand. In other words, return to calm is far being the case for the entire market, and divergences are still wide from one country or one sector to another.

**Don't try to catch a falling knife.** The valuation of a market – unless it has bottomed out, which is not currently the case – is seldom reason enough to buy. **We therefore continue our review with an assessment of earnings forecasts**, focusing on sector outlooks, as they are very uneven and therefore highly instructive.

Let's start our comparison in **late 2007**, before the financial crisis peaked. Since then, **EPSs have risen by 32% in the US** while falling 46% at the same time in the euro zone. Between these two extremes are Japan (-6%), emerging markets (-20%), and the UK (-26%).

The main reason that the euro zone is so far behind the rest of the world is that it has experienced **two recessions** during that time, vs. just one for the other regions. Another reason is that **the euro remained very strong** for a long time, which squeezed EPSs, as expressed here in local currency (with the exception of emerging markets in USD). From one region to the next, **sector weightings are very different, which can also skew comparisons.** For example, the US was driven by the momentum and weight of its tech sector (20% of the MSCI US vs. just 4% in Europe), whereas the euro zone has suffered from the difficulties of financials and utilities (respectively, 19% and 6% of the MSCI EMU), which together account for 25% of the index.

**More recently, since July 2014 there has been a shift in trend in the MSCI World AC**, with, for the first time since the financial crisis of 2008, a prolonged decline in EPSs (see chart 2).

While this decline is nowhere near as great the drop of 2008, **it is comparable in duration.** As in 2008, the decline is not restricted to one or two regions but has been almost universal. For example, with the notable exception of the euro

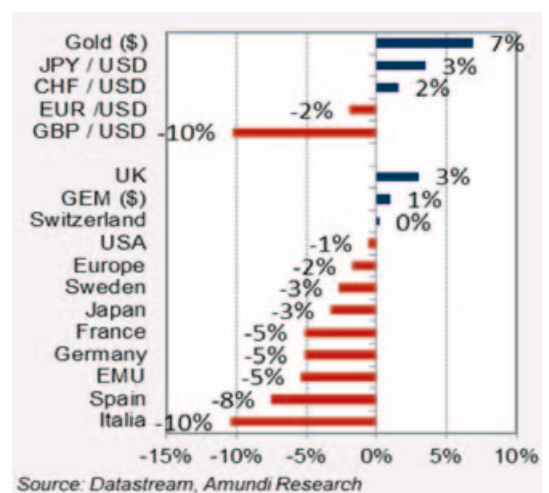
The essential

**The article assesses the credibility of consensus earnings forecasts by focusing on sector components.**

While no one will be surprised by the anaemic growth forecast in the MSCI World AC in 2016 (+2%), the rebound forecast for 2017 (+13%) and 2018 (+12%) is intriguing. A closer look reveals that assumptions are more than 50% based on the energy and basic materials sectors, which together account for just 12% of the index. In 2018, the same sectors are expected to account for almost 30% of the total rebound. While a steep rebound in these sectors is quite plausible for 2017, this will be less the case in 2018. Meanwhile, visibility is still very low on financials, which are also expected to make a big contribution to earnings growth in 2017 and 2018. Given their uneven distribution and low visibility, sector allocations will be even more crucial than usual.

“Earnings sector biases are highly instructive”

1 Gold, Forex and (local) MSCI indexes price changes from June 23 to July 4, 2016



zone, which has rallied tentatively over the past few months, the other regions have seen a steady decline in their EPSs – the UK since August 2012, emerging markets since September 2014, the US since October 2015, and now Japan since April 2016.

As to the reasons for this decline, **slower global economic growth** in 2015, particularly in emerging markets, **may have played a role**, but a secondary one, given the limited drop of Emerging EPSs in 2015 (-7%) and their low weighting in the indices (11% of the MSCI World AC). **However**, with the collapse in commodities prices, **sector aspects have played out in full**.

**For example, within the MSCI World AC, 2015 EPSs in basic materials and oil fell, respectively, by 26% and 54%.** These sectors each account for 5% and 7% of the index. All other factors being equal, the drop in their EPSs accounted for roughly 500 basis point drop. In other words, **apart from these two sectors, instead of falling 3%, 2015 EPSs of the MSCI World AC would have continued to rise by about +2%** (see chart 3).

**If this sector impact was decisive in 2015, what about now?** For the current year and the next two, the IBES consensus of analysts is for an EPS growth of +2% in 2016, +13% in 2017 and +12% in 2018. While no one is surprised by the weak 2016 numbers, the projected acceleration beginning in 2017 looks surprising. The US cyclical recovery has already reached its asymptote by far; there are new threats in Europe since Brexit; Abenomics and the yen's depreciation have petered out; and the Chinese engine is having a hard time maintaining speed.

For a better assessment, a view of sector contributions is once again highly instructive. **For example, the almost doubling of EPSs in energy in 2017 is expected to contribute as much as 700 basis points.** In other words, the +13% gain in EPSs of the MSCI World AC in 2017 is expected to come mostly from this one sector and, to a lesser extent, to the recovery in basic materials and financials.

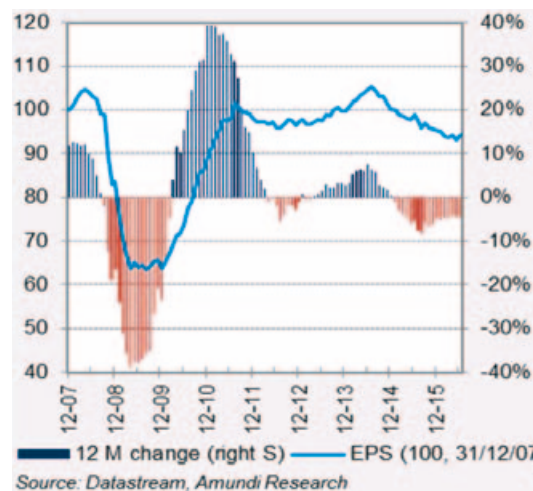
**However, such an uneven increase in profits does raise many questions**, as a recovery on such a narrow base looks shakier and, above all, unlikely to be self-sustaining. While a sharp upturn in energy and basic materials in 2017 is highly plausible, given their low starting points, this will be less the case in 2018. Similarly, in light of negative interest rates, the economic, political and regulatory environment, as well as the market environment, visibility on financials remains very low.

**Regarding the energy sector, our baseline assumption is that oil prices should level out in a range between \$50 to \$55 over the next 18 months.** They had fallen four-fold from June 2014 to January 2015 (from \$114 to \$28) but have begun to make up this lost ground. Our 12-month rolling comparison, thus far highly unfavourable, should become less demanding early next year. Against this backdrop, between more favourable price effects and lower exceptional charges, the sector's results, while not doubling, should be much better. However, for 2018, barring a true improvement in the economic environment and further gains in oil prices to about \$65-70, a new 38% rebound in the energy sector and, hence, a +12% rebound in MSCI World AC earnings seems unlikely. To say nothing of financials, where visibility is lacking.

**After this global overview, let's take the same approach to individual regions.**

In the **euro zone**, the consensus expects earnings to be up slightly in 2016 (+2%), followed by a steep acceleration thereafter (+14% in 2017 and +11% in 2018). As with the MSCI World AC, these earnings will also depend mostly on energy and basic materials (a delta of +510 basis points between 2016 and 2017), as well as financials. According to IBES, after squeezing 2016 results, by 6%, or 130bp, **financials** could turn up in 2017 by 15%, or 370bp. However, as the euro zone is being hit especially hard by Brexit fallout and negative interest rates, **visibility on the sector is quite limited**. With more than half of the euro zone's non-performing loans, Italian banks are at the epicentre of the crisis. How those NPLs are address will be key, and this is an issue that Europeans

## 2 Earnings per share of the MSCI World AC



## 3 MSCI World AC Sector weight & EPS growth

MSCI AC World	Weight	EPS growth			
		2015	2016	2017	2018
IT	15%	4%	3%	13%	12%
Cons. Discretionary	12%	8%	11%	13%	11%
Health Care	12%	10%	7%	11%	11%
Energy (1)	7%	-54%	-41%	96%	38%
Utilities	4%	6%	-4%	4%	7%
Industrials	10%	-3%	11%	11%	10%
Telecom Services	4%	4%	7%	9%	9%
Materials (2)	5%	-20%	7%	17%	13%
Financials (3)	20%	6%	-1%	10%	9%
Consumer Staples	11%	-1%	5%	10%	9%
<b>Total</b>	<b>100%</b>	<b>-3%</b>	<b>2%</b>	<b>13%</b>	<b>12%</b>
ow Energy (1) & Mat. (2)	12%	-5%	-3%	8%	3%
ow Financials (3)	20%	1%	0%	2%	2%
<b>Total ex 1, 2, 3</b>	<b>68%</b>	<b>1%</b>	<b>5%</b>	<b>4%</b>	<b>7%</b>

Source: Datastream, Factset, Amundi Research

## 4 MSCI EMU Sector weight & EPS growth

MSCI EMU	Sector weight	EPS growth by sector			
		2015	2016	2017	2018
IT	6%	17%	-1%	20%	14%
Cons. Discretionary	14%	-3%	29%	12%	7%
Health Care	10%	11%	5%	7%	9%
Energy (1)	6%	-35%	-23%	46%	27%
Utilities	5%	-4%	-3%	2%	4%
Industrials	12%	7%	8%	11%	12%
Telecom Services	6%	17%	11%	14%	11%
Materials (2)	7%	4%	-1%	15%	12%
Financials (3)	21%	17%	-6%	17%	10%
Consumer Staples	13%	8%	-1%	10%	8%
<b>Total</b>	<b>100%</b>	<b>5%</b>	<b>2%</b>	<b>14%</b>	<b>11%</b>
ow Energy (1) & Mat. (2)	12%	-3%	-1%	4%	2%
ow Financials (3)	21%	4%	-2%	4%	2%
<b>Total ex 1, 2, 3</b>	<b>66%</b>	<b>3%</b>	<b>5%</b>	<b>7%</b>	<b>6%</b>

Source: Datastream, Factset, Amundi Research

are currently divided on. With the findings of the ECB's coming stress tests due out on 29 July, this issue should play out in the coming weeks and will be decisive in assessing the sector's earnings forecasts.

In the **United States**, after +1% forecast for 2016, it may also seem strange for earnings to rebound so strongly in 2017 (+14% forecast), as they have clearly been in an expansion cycle for a long time. But in the US, more than elsewhere, the rebound is mostly an optical illusion. While the US oil sector has almost the same weighting in the indices as in Europe, it is far more upstream and therefore was hit harder by falling oil prices. Conversely, beginning in 2016, it is likely to benefit more from higher oil prices, with **energy's contribution to stronger US earnings leaving the other sectors behind**.

Conversely, in **Japan**, energy is very lightly weighted in the indices (less than 1% of the MSCI Japan). So it will have only a tiny positive impact on 2016 results. This raises a red flag on the +15% global consensus forecast. A closer look finds that it makes big assumptions on a strong improvement in industrial and IT sectors. Given the **JPY's year-to-date gains** (more or less 20% vs. the USD, the EUR and CNY), we are somewhat sceptical.

In **emerging markets**, sector biases are actually rather balanced. Like elsewhere, a significant improvement is forecast in earnings in 2017 in energy, basic materials and finance, as well as in industry and IT. In other words, **this improvement would be broad-based**. This encouraging scenario would be consistent with expectations of relief for commodities-exporting countries and relatively accommodating financial conditions, given the only minor tightening - if any- expected from the Fed and a decline in risk aversion.

**In conclusion**, when looking at future earnings, as the means used are misleading, a sector-based assessment has become essential. Globally, given the fallout from the commodities crisis, EPSs of the energy and basic materials sectors will play a key role in the rebound in 2017 but with no guarantee that it will stay as strong in 2018. Regionally, in the euro zone, while the commodities component of the 2017 earnings rebound is not at issue, the strong increase forecast from financials is less certain (due to Brexit fallout, negative interest rates, how the Italian crisis is dealt with, etc.). In the United States, the possibility cannot be ruled out of surprisingly good 2017 earnings, but this would be mostly an optical illusion, skewed by the expected tripling in energy sector earnings. And in emerging markets, earnings growth seems rather well balanced, which would be a good sign for their sustainability.

## 5 MSCI USA Sector weight & EPS growth

MSCI USA	Sector weight	EPS growth by sector			
		2015	2016	2017	2018
IT	20%	7%	2%	12%	12%
Cons. Discretionary	13%	14%	14%	13%	14%
Health Care	15%	12%	8%	11%	11%
Energy (1)	7%	-62%	-70%	249%	55%
Utilities	4%	-1%	3%	4%	7%
Industrials	10%	-1%	4%	10%	11%
Telecom Services	3%	13%	4%	5%	5%
Materials (2)	3%	-5%	0%	15%	8%
Financials (3)	16%	14%	0%	11%	11%
Consumer Staples	10%	0%	4%	10%	9%
<b>Total</b>	<b>100%</b>	<b>0%</b>	<b>1%</b>	<b>14%</b>	<b>13%</b>
ow Energy (1) & Mat. (2)	10%	-5%	-5%	nm	4%
ow Financials (3)	16%	2%	0%	2%	2%
<b>Total ex 1, 2, 3</b>	<b>74%</b>	<b>3%</b>	<b>6%</b>	<b>nm</b>	<b>7%</b>

Source: Datastream, Factset, Amundi Research

## 6 MSCI Japan Sector weight & EPS growth

MSCI Japan	Sector weight	EPS growth by sector			
		2015	2016	2017	2018
IT	10%	-8%	8%	7%	7%
Cons. Discretionary	21%	9%	-5%	14%	9%
Health Care	9%	67%	3%	9%	9%
Energy (1)	1%	-13%	175%	15%	25%
Utilities	2%	52%	-31%	5%	17%
Industrials	20%	-37%	81%	8%	7%
Telecom Services	6%	3%	17%	11%	14%
Materials (2)	5%	-17%	15%	15%	10%
Financials (3)	17%	-1%	1%	2%	3%
Consumer Staples	9%	7%	18%	11%	9%
<b>Total</b>	<b>100%</b>	<b>-3%</b>	<b>14%</b>	<b>9%</b>	<b>8%</b>
ow Energy (1) & Mat. (2)	6%	-1%	2%	1%	1%
ow Financials (3)	17%	0%	0%	0%	1%
<b>Total ex 1, 2, 3</b>	<b>77%</b>	<b>-2%</b>	<b>11%</b>	<b>7%</b>	<b>6%</b>

Source: Datastream, Factset, Amundi Research

## 7 MSCI Emerging Markets Sector weight & EPS growth

MSCI Emerging	Sector weight	EPS growth by sector			
		2015	2016	2017	2018
IT	23%	-6%	5%	15%	15%
Cons. Discretionary	10%	-1%	13%	15%	11%
Health Care	3%	21%	17%	20%	17%
Energy (1)	7%	-80%	-21%	34%	21%
Utilities	3%	32%	-8%	4%	6%
Industrials	6%	83%	5%	18%	10%
Telecom Services	7%	-5%	10%	10%	9%
Materials (2)	6%	-79%	ns	12%	15%
Financials (3)	26%	4%	1%	9%	10%
Consumer Staples	8%	8%	18%	16%	11%
<b>Total</b>	<b>100%</b>	<b>-7%</b>	<b>6%</b>	<b>14%</b>	<b>12%</b>
ow Energy (1) & Mat. (2)	14%	-8%	ns	3%	2%
ow Financials (3)	26%	1%	0%	2%	3%
<b>Total ex 1, 2, 3</b>	<b>60%</b>	<b>0%</b>	<b>6%</b>	<b>8%</b>	<b>7%</b>

Source: Datastream, Factset, Amundi Research

**6 Japanese real-estate and investors: a passionate but unstable relationship**

MAHFOUD DELAL, *Strategy and Economic Research*

The real-estate investment trusts (REITs) index has outperformed the Topix impressively since the introduction of negative interest rates. In addition to the traditional benefits of investing in real-estate, such as leverage, tax breaks, diversification, low volatility in yields, and inflation protection, there are features unique to the Japanese market that make it more attractive. The sector is getting a boost in particular from official economic growth strategy.

As corporate profits have risen sharply in recent years, office real-estate has benefited to a certain extent from the improvement in the labour market and investment. The average vacancy rate in office real estate shrank to 4.05% in May and has fallen steadily since July 2012. Naturally, rents have risen since January 2014, and averaged 5477 yen per square meter in May 2016 for new and existing property reached (+11.5% during the period), a six-year high.

And yet, Tokyo's five CBD quarters (Minato, Shibuya, Shinjuku, Chiyoda, and Chuo) have seen less and less construction, with its number falling from 2659 units in March 2013 to 2601 in May 2016. Our impression of abundant construction is at odds with these figures, due to the fact that construction is often due to relocations into existing buildings to bring personnel together.

Foreign tourist numbers in Japan have risen constantly over the past four years, thanks to easier conditions for obtaining a visa, a wider range of goods eligible for tax deductions, the recent development of airport infrastructures for low-cost airlines, and increased per capital GDP in Asia. Based on the real effective exchange rate, the depreciation of the yen until the end of 2015 has also played an important role but tourist numbers have continued to rise since the yen began appreciating in June 2015 (based on the real effective exchange rate). Whereas demand has caught up with supply, construction of new infrastructure is being driven by the government's raising of its objective (from 20 to 40 million by 2020). Infrastructure occupancy rates in Tokyo and Osaka are considerably higher than other major cities, such as Paris and New York, which gives hotel managers greater pricing power.

The Bank of Japan (BoJ) has enlivened the market by deciding to invest 90 billion yen in real-estate funds annually since the launch of the second quantitative easing programme (QQE2) in late 2014.

Construction starts have been favourable since February 2016, with growth of almost 9.0%, constantly beating market expectations by far. The introduction of negative rates since 29 January has had a heavy impact on the sector. In March real-estate lending hit a high since the US real-estate bubble. Total available rental surface area surged by 1.8% from January to May, vs. an increase of just 0.25% for all of 2015.

The impact of the low-interest-rate environment has thus been amplified, drawing in risk-averse and yield-starved investors to this sector, where the 3.13% dividend yield is higher than the average of companies of the flagship index Topix (2.32% as of the end of June 2016).

However, the biggest fans are not local investors, but foreign ones, who have invested massively in this sector since February. Their investments are focused on REITs rather than real-estate developers, as they offer higher yields. At the end of June 2016, REIT dividends were 3.13% vs. 1.30% for developers.

So the question is why Japanese investors, who don't have many investment opportunities on their domestic market, did not seize the opportunity of the local real-estate market? Strangely enough, Japanese investors have stepped up their exposure in international REITs rather than domestic ones at a time when foreigners are arriving massively on the Japanese market. In March the 10 investment funds, all asset classes combined, with the largest net inflows include six REITs specialising in international assets, five of which are at the

**The essential**

**The Japanese real-estate market is at the heart of the current debate on excessively low interest rates. Real-estate is an attractive asset class.**

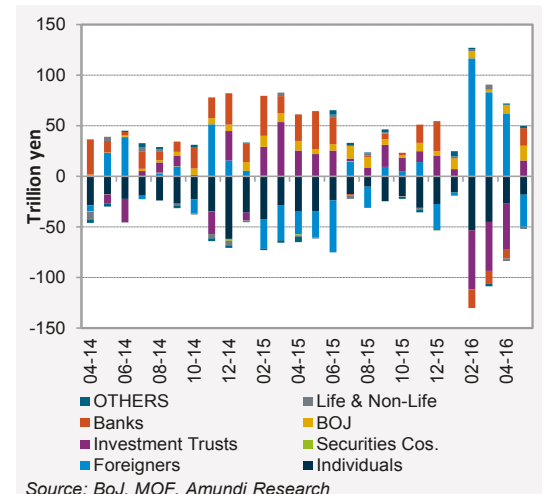
While real-estate developers are getting a clear boost from negative interest rates with the option of borrowing at low cost to invest in new construction or to enhance shareholder return, real-estate investment trusts have benefited the most as share prices are up sharply so far this year. The two highlights of the first half of 2016 – the introduction of negative interest rates and the UK referendum on leaving the European Union – confirmed demand in this sector with a considerable rally in the underlying index.



The real estate market should continue to perform well as long as the market is supported by easy money from central banks and low real interest rates, attracting international buyers to Japanese assets



**1 Flow of fund in J-REIT**



top of the list. In addition to offering dividends that are even higher than REITs exposed to domestic assets, these funds seem to be gradually modifying their mode of remuneration from profit-sharing (based on capital appreciation) to a management bonus (based on the fund's total amount) to cope with the difficulties involved in capital gains. Moreover, there is a correlation between the best-selling funds and the level of sales commissions, which are often above 3.0%.

However, the latest data, from May 2016, point to a return by local banks and investment trusts, with net positive inflows, whereas foreign investors appear to have become impatient after a large profit-taking resulting in negative net outflows. After three months of massive inflows (with a second all-time record in February), following the introduction of negative interest rates, foreign investors did not see domestic inflows onto the market, except those of the Bank of Japan (BoJ) (see chart 1).

Meanwhile, the recent expansion raises the matter of an overheated market with excessive valuations. Indicators such as price/book value (P/BV) and price/earnings (P/E) ratios may seem relatively high in comparison with their average since the launch of quantitative easing. However, this is true only for REITs (current values of 1.52x and 31.9x for mid-sized ones of 1.4x and 30.8x, respectively), while real-estate developers are also benefiting from the current environment even through their payout to shareholders is not as high.

Meanwhile, as cross-border inflows and outflows have increased recently, an international comparison is worth making. In terms of indices and on a standardised basis, while the US market is far above its peak reached during the real-estate bubble of February 2007, the Japanese market still offers some upside potential.

Fundamental ratios tell us a little more, with a study by the US firm JLL. Of the 15 major cities concerned, Japan ranks sixth in terms of price/income ratio, behind Hong Kong, Singapore and New York, which may seem high. However, Japan ranks 11th in price/rent ratio, thus suggesting that the market is relatively undervalued and highly competitive.

There is still some room for the vacancy rate to improve. The latest release is still 159 basis points above the 2.46% record of November 2011. Office real estate accounts for more than 46% of the exposure of the 54 REITs located in Japan, making the vacancy rate an important contributor to rental pricing power.

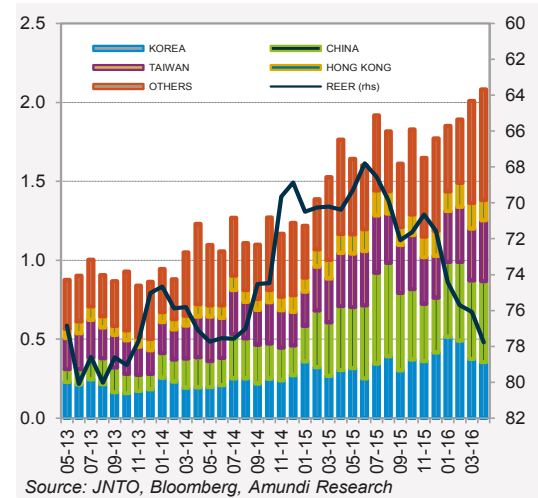
The average expected rent is at a high since May 2010 and has risen sharply since Prime Minister Abe took office, driven by inflationary pressures. So a key item will be whether rents can continue to rise.

We believe the sector still has some upside potential in an advantageous environment. The 2020 Olympic Games will provide support to construction and renovation for at least the next two years. Beyond 2020, there are doubts on the ability to maintain growth in the number of visits after the "last" inflow that Japan will probably have reached during the Olympics.

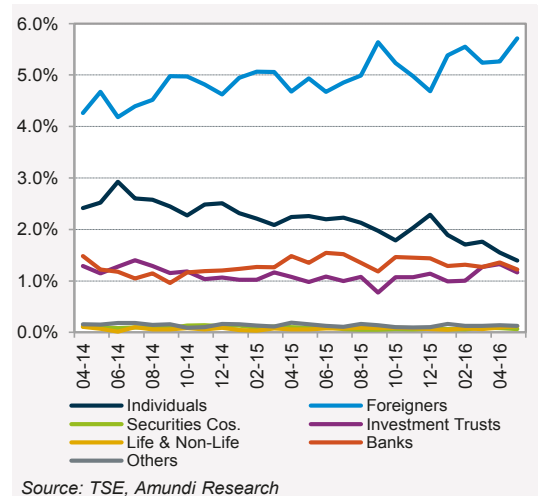
Meanwhile, in an environment in which investment opportunities are becoming scarcer, investors are seeking assets that add fixed income streams to their portfolios. Generally speaking, the search for higher yields makes investors turn toward other asset classes, such as high yield bonds, high-yielding equities, or preference shares. Real estate can also serve as an alternative asset class.

The introduction of negative interest rates has amplified this effect and domestic investors such as trusts and regional banks are taking an interest in this type of investment. As regional banks are less exposed than "mega-banks" to brokerage activities and loans to foreign clients, their lack of diversification in terms of business lines makes them more likely to take on exposure to this attractive sector, given the current environment.

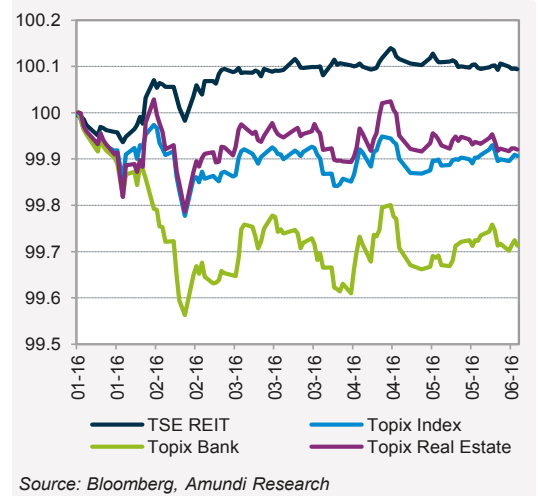
## 2 Evolution of number of tourists and real effective exchange rate



## 3 Trading share by investor type



## 4 Indices performance (100 basis)



**7 The US construction sector outlook still favourable**

LAURENT PARIS, *Equity Analysis*

Following the bursting of the US real-estate which began in 2006 and the resulting collapse in the construction market, the sector began to recover robustly in 2012, driven by a steady improvement in the main economic indicators and the shale gas boom. Today, after four years of relatively sustained growth and in a global economic environment that remains challenging and marked by the steep drop in oil prices, it is worth asking whether this rebound can go on, given that it has been one of the main drivers of earnings growth by major international construction material groups, cement in particular. The purpose of this article is to provide an update on the major trends in US construction segments (residential, private non-residential, and public non-residential).

**Residential construction still offers some growth potential**

In the midst of the 2007-2009 crisis, the US residential construction shrank by almost 60% from 2006 to 2011. But since bottoming out in 2011 the market has rallied sharply, doubling in four years. However, it is still far below its 2005 level. While at this stage it is certainly premature to imagine a return to pre-crisis levels, the current level is still below its normalised potential level. Based on housing starts, for example, which is this segment's main indicator, growth continued in early 2016 with almost 1.2m housing starts in April (on an annualised basis). As chart 2 shows, this pace is twice as fast as in 2010 but far below the long-term (30-year) average of almost 1.4m units, as well as the potential of the underlying market, which is estimated at closer to 1.5m units, based on US population growth over the last 10 years. A mere return to the long-term average in 2018 would mean annualised growth of 8% (vs. 16% between 2011 and 2015).

The main factors in favour of residential investment are still in place, including low unemployment, an upturn in the household formation, the net age of real-estate stock (incidentally, often of average quality), housing stock back to historical averages, an upturn in demand for single-family housing (whereas multi-family housing had been the focus in the immediate post-crisis period), and higher rents. While the main risk seems to be in the sharp increase already seen in housing prices (the Case Schiller index of the 20 largest cities is up 38% since 2012) and a potential increase in interest rates, the quality of mortgage lending has improved considerably, driven by legal constraints. All in all, our baseline scenario is for further growth in private residential property of about 7-8% annually. This trend has mostly been confirmed in 2016 by the 12% increase in building permits in 2015.

**The non-residential private construction market hit by the slowdown in manufacturing**

Traditionally lagging behind residential construction, private non-residential construction (which mainly includes offices, retail property, hotels, healthcare facilities, and energy and manufacturing infrastructure) peaked in 2008. While it has not been spared by the crisis, it fell less, (by almost 45%) than residential real-estate. Since bottoming out in 2011, it has risen over the past four years and is no longer very far from its highs.

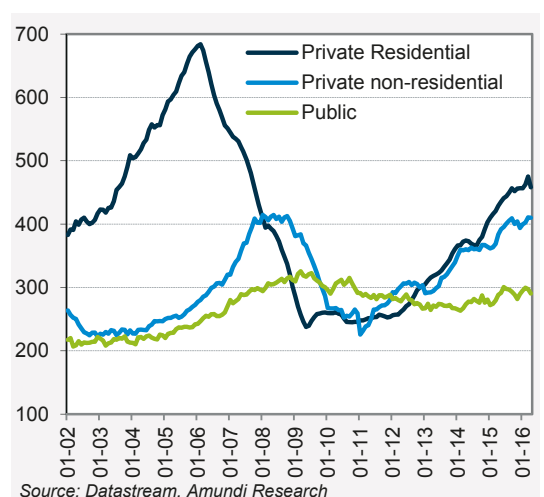
Despite the sharp drop in oil prices, growth remained strong in private non-residential real-estate in 2015, driven by the relative inertia of industry and the beneficial effects of lower oil prices on consumer spending. After expanding by 16% in 2014, private non-residential investment rose again by almost 8% in 2015. Two main segments drove this performance in 2015: manufacturing (+33% in 2015) and offices and hotels (respectively +21% and +30%). Manufacturing reflects the momentum created by shale gas, while offices were driven by the economic upturn, including lower unemployment and the IT start-up boom (which has boosted demand for offices). These two sectors are now showing signs of running out of steam, with the end of the Internet start-up boom, a

**The essential**

**Following the bursting of the US real-estate which began in 2006 and the resulting collapse in the construction market, the sector began to recover robustly in 2012.**

Today, after four years of relatively sustained growth and in a global economic environment that remains challenging and marked by the steep drop in oil prices, it is worth asking whether this rebound can go on. Based on a review of the various construction segments (residential, private non-residential and public non-residential), we believe that the drivers of growth are still there. While the pace of recent years does not look sustainable, the outlook for the US construction sector remains favourable.

**1 US construction spendings (\$bn)**



more challenging basis of comparison, the completion of major liquefied natural gas projects and large petrochemical crackers, the appreciation in the dollar, etc. The main risk is in manufacturing, as seen in the downturn in the PMI Manufacturing index and industrial output since last autumn. Even so, despite a dip of about 5-6% estimated (by Portland Cement Association) for 2016 in manufacturing, the relative resiliency of other segments should lead to slight growth in private non-residential real estate this year. All in all, the slowdown in private non-residential real estate points to a possible downturn after 2016.

### Is public-sector construction now in a recovery phase?

Between 2009 and 2014, the US public-sector construction sector shrank by about 20% in real terms, due mainly to the challenging fiscal situation in the US, while federal infrastructure spending was relatively flat. We now see several factors likely to lead to an upturn in public infrastructure spending:

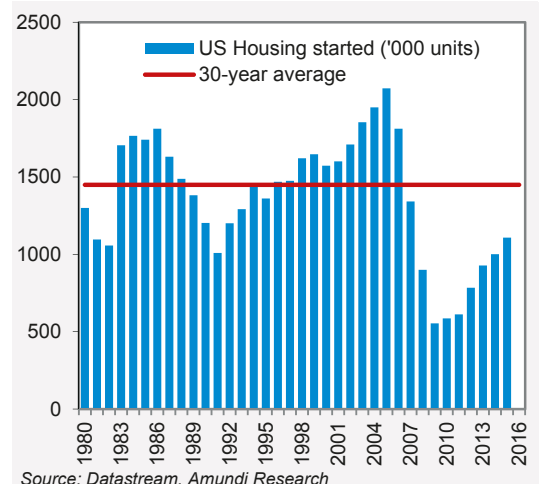
- i. The ongoing improvement in the job market has helped strengthen the financial situation of the states. On average, the states' forecast a 3% increase in their spending for 2015-16. Several states, such as Texas, North Carolina, Georgia, and Florida have expanded their infrastructure budgets considerably, while various sources of financial leverage have been stepped up in recent years.
- ii. Last December's passage of a new multi-year infrastructure funding law (Fixing America's Surface Transportation Act (the FAST Act), which for the first time since 2009 guarantees five-year financing of motorway infrastructure construction. According to the American Road & Transportation Builders Association (ARTBA), this new law provides for a 0.5% annual increase over five years in infrastructure spending (adjusted for inflation and project costs).
- iii. Heavier road traffic, due to lower fuel prices. In 2015, the number of miles travelled rose by 4% for the first time since 2007. As the fuel tax is fixed and has not changed since 1993 (18.4 cents per gallon of gasoline and 24.4 cents for diesel). Increased traffic is likely to result in higher tax receipts, which will be allocated to funding motorway construction.

The combination of these factors looks favourable to a recovery in public-sector construction, but this should be moderate. Note that expectations are not very high (between 2.5 and 3.0% growth).

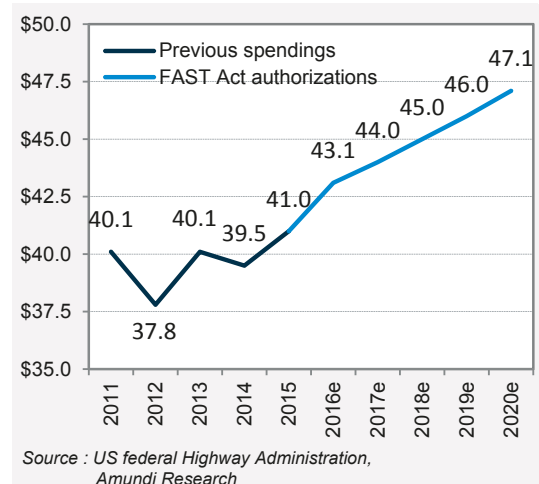
### Conclusion

All in all, US private residential indicators still look good, confirming the prospect of new growth in 2016. Even so, this could be slowed by the already high prices of real estate and a possible squeeze on mortgage lending rates. Meanwhile, private non-residential construction is showing signs of running out of steam, due to the postponement of new major gas and chemicals projects and the slowdown in the manufacturing sector caused by lower oil prices. However, public-sector construction spending could see an improvement, driven by the improvement in transport infrastructure spending. Although the pace of recent years does not appear to be sustainable, US construction is likely to continue expanding robustly.

## 2 US Housing starts



## 3 US FAST Act: highway spending authorizations (\$bn)



“ Although the pace of recent years does not appear to be sustainable, US construction is likely to continue expanding robustly ”

## Recent publications

### Working Papers

- **The Reactive Covariance Model and its implications in asset allocation**  
EDUARDO ABI JABER, *Quantitative Analyst – ENSAE ParisTech*, DAVE BENICHO, *Portfolio Manager*, HASSAN MALONGO, *Quantitative Research*
- **On the stationarity of dynamic conditional correlation models**  
JEAN-DAVID FERMANIAN, *Professor of Finance & Statistics, CREST/ENSAE*, HASSAN MALONGO, *Quantitative Research*
- **Asset Allocation under (one's own) Sovereign Default Risk**  
DIDIER MAILLARD, *Professor – Cnam, Senior Advisor – Amundi*
- **Designing a corporate bond index on solvency criteria**  
LAUREN STAGNOL – *Quantitative Research*
- **Which lever can enhance sustainability in emerging market countries? A stochastic approach to better grasp public debt dynamics**  
ANNE-CHARLOTTE PARET – *Strategy and Economic Research*

### Discussion Papers Series

- **Low/negative interest rate environment, secular stagnation... implications for asset management**  
PHILIPPE ITHURBIDE – *Global Head of Research, Strategy and Analysis*
- **Forex markets: the nuts and bolts of the carry factor**  
LEZMI EDMOND, *Quantitative Research*
- **The financial markets today: how to cope with low/negative interest rates**  
PHILIPPE ITHURBIDE – *Global Head of Research, Strategy and Analysis*

### Special Focus

- **South Africa: is the political climate responsible for the growth decline?**  
KARINE HERVÉ, GWENDOLINE IBRE – *Strategy and Economic Research*
- **Negative rates: a potentially counter – productive and stress inducing measure**  
PHILIPPE ITHURBIDE – *Global Head of Research, Strategy and Analysis*
- **Is the ECB running out of leeway? Some thoughts before the March 10 governing council**  
VALENTINE AINOUIZ, BASTIEN DRUT – *Strategy and Economic Research*

### Contributors

#### Editor


– PHILIPPE ITHURBIDE  
*Head of Research, Strategy and Analysis – Paris*

#### Deputy-Editors

– DIDIER BOROWSKI – *Paris*, RICHARD BUTLER – *Paris*, ÉRIC MIJOT – *Paris*,  
MO JI – *Hong Kong*, STÉPHANE TAILLEPIED – *Paris*


#### Support

– PIA BERGER  
*Research, Strategy and Analysis – Paris*  
– BENOIT PONCET  
*Research, Strategy and Analysis – Paris*



## Amundi Research Center

Top-down  
**Asset Allocation**  
Bottom-up  
**Corporate Bonds**  
**Fixed Income**



Foreign Exchange  
Money Markets  
Equities

Find out more about  
**Amundi research team**  
[research-center.amundi.com](http://research-center.amundi.com)

Monetary Policies  
Forecasts  
**Investment Strategies**  
Quant  
**Emerging Markets**  
Sovereign Bonds  
**Private Equity**  
Real Estate  
**High Yield**

### DISCLAIMER

Chief editor: Pascal Blanqué

Editor: Philippe Ithurbide

In the European Union, this document is only for the attention of "Professional" investors as defined in Directive 2004/39/EC dated 21 April 2004 on markets in financial instruments ("MIFID"), to investment services providers and any other professional of the financial industry, and as the case may be in each local regulations and, as far as the offering in Switzerland is concerned, a "Qualified Investor" within the meaning of the provisions of the Swiss Collective Investment Schemes Act of 23 June 2006 (CISA), the Swiss Collective Investment Schemes Ordinance of 22 November 2006 (CISO) and the FINMA's Circular 08/8 on Public Advertising under the Collective Investment Schemes legislation of 20 November 2008. In no event may this material be distributed in the European Union to non "Professional" investors as defined in the MIFID or in each local regulation, or in Switzerland to investors who do not comply with the definition of "qualified investors" as defined in the applicable legislation and regulation. This document is not intended for citizens or residents of the United States of America or to any "U.S. Person", as this term is defined in SEC Regulation S under the U.S. Securities Act of 1933.

This document neither constitutes an offer to buy nor a solicitation to sell a product, and shall not be considered as an unlawful solicitation or an investment advice.

Amundi accepts no liability whatsoever, whether direct or indirect, that may arise from the use of information contained in this material. Amundi can in no way be held responsible for any decision or investment made on the basis of information contained in this material. The information contained in this document is disclosed to you on a confidential basis and shall not be copied, reproduced, modified, translated or distributed without the prior written approval of Amundi, to any third person or entity in any country or jurisdiction which would subject Amundi or any of "the Funds", to any registration requirements within these jurisdictions or where it might be considered as unlawful. Accordingly, this material is for distribution solely in jurisdictions where permitted and to persons who may receive it without breaching applicable legal or regulatory requirements.

The information contained in this document is deemed accurate as at the date of publication set out on the first page of this document. Data, opinions and estimates may be changed without notice.

You have the right to receive information about the personal information we hold on you. You can obtain a copy of the information we hold on you by sending an email to [info@amundi.com](mailto:info@amundi.com). If you are concerned that any of the information we hold on you is incorrect, please contact us at [info@amundi.com](mailto:info@amundi.com)

Document issued by Amundi, a société anonyme with a share capital of €596,262,615 - Portfolio manager regulated by the AMF under number GP04000036 – Head office: 90 boulevard Pasteur – 75015 Paris – France – 437 574 452 RCS Paris [www.amundi.com](http://www.amundi.com)

Photo credit: iStock by Getty Images – Sean Pavone