

Confidence
must be earned

Amundi
ASSET MANAGEMENT

Key investment convictions for the short and long term



“ Moving towards a more challenging mid-term scenario with lower return expectations, investors should reconsider their investment approaches. While focusing on extracting the value left in the market in the current economic phase, it is also time to rethink long-term strategies with a focus on how to build asymmetric payoff profiles that limit the downside when the correction comes while still capturing long-term risk premia. ”

Pascal Blanqué,
Group Chief Investment Officer

KEY QUESTIONS FOR INVESTORS

1. What are the key themes for investors?
2. What are the investment convictions for the short and mid-term?
3. What should be the investment approach for the long term?



Pascal BLANQUÉ
Group Chief
Investment Officer

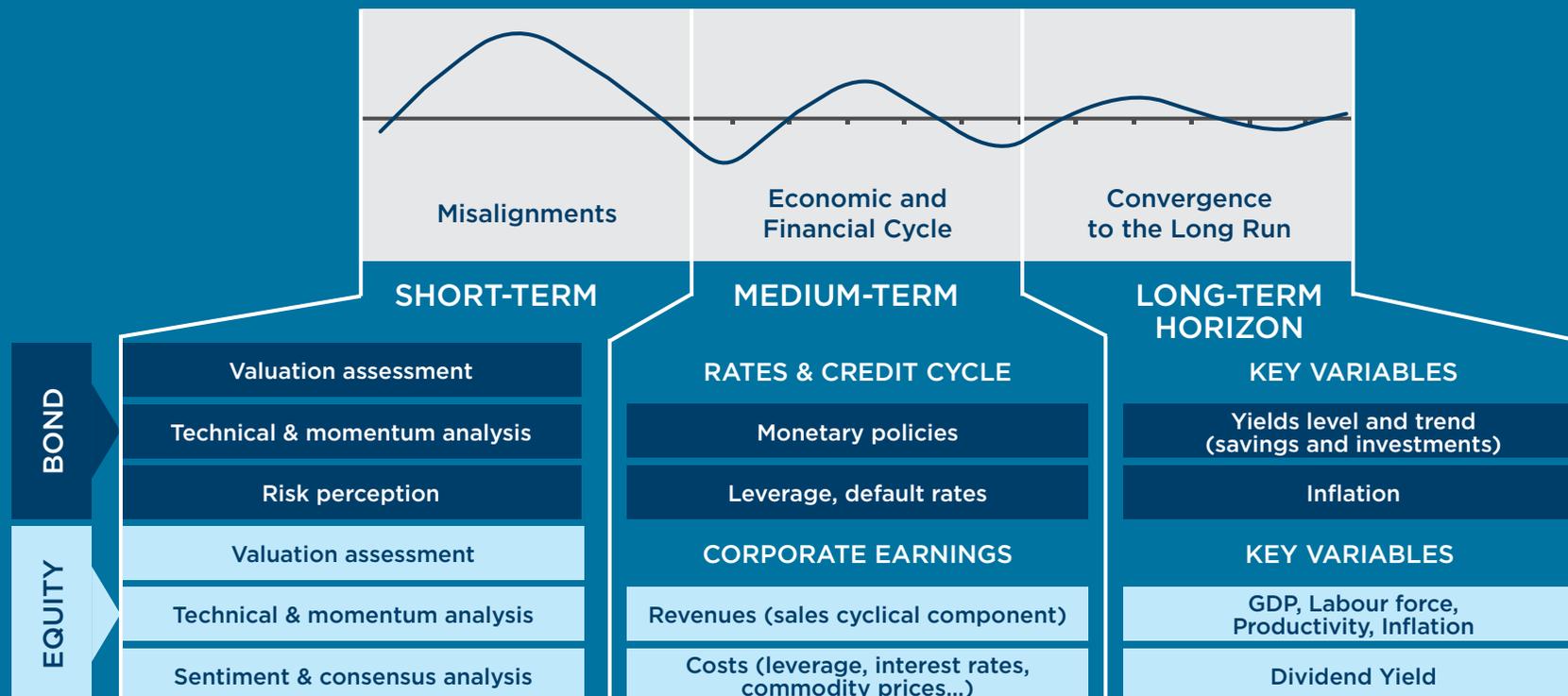
Long-term investing is about the belief that fundamental value exists and that asset class returns tend to mean revert to their equilibrium level and rotate around it, within regimes. Every regime is defined by its mean/equilibrium, based on economic and credit cycles (and depends on a number of factors, including monetary and fiscal conditions). Detecting market inefficiencies and misalignments around these trends is the essence of active management. Among the reasons behind the current misalignments are excessive risk taking (especially in the credit market) induced by Central Banks' quantitative easing policies, inefficiencies due to the retreat of research coverage in some areas of the market (ie, Japan) and the emergence of crowded trades in relation to the "benchmark-sation" of the markets (with a high concentration of risk in certain components of the indexes, typically large/giant firms and in the sectors represented). Although these distortions may result in significant challenges for investors, they also open opportunities for active managers to add value for the long term.

With a long-term perspective, macroeconomic variables are the main drivers of interest rates and earnings growth and therefore of the asset returns. Among these variables, the most important with a long-term view are: demographics, productivity growth, debt dynamics and changes in labour force and in capital formation. We think that the underlying trends affecting these variables (ageing population, sluggish productivity growth, high debt) point to a low interest rate at equilibrium and to equity returns (and earnings growth) around the long-term trend (about 6.5% for the US market). This will translate into lower return potential for a balanced portfolio in the future compared to the last 10 years.

With a shorter-term perspective, the current regime shift is a key topic, given we stand now at a critical juncture. On one side, there is the temptation to see an extension of the cycle in the US and an upward trend in earnings; however, we also see signs of a maturing cycle: global growth is at peak, global liquidity is expected to diminish, and leverage is creeping up in a context of high debt. Low interest rates make high risk asset valuations more sustainable (with stretched situations in some area of the market, such as growth stocks). However, we should consider that most of the monetary component of returns (falling rates) is behind us, and unless we see a structural increase in productivity growth (not on the radar), we can expect equity returns to be back to long-term averages. While the current phase of strong economic growth and relatively benign Central Banks still favours some risk exposure (equities attractive vs bonds, and bonds are expensive), we acknowledge that the medium term could prove more challenging. The era of ultra low volatility is coming to an end, and investors should start to prepare portfolios for the next, less benign, phase, recalibrating risk. Value and quality are themes to consider in this phase as well a flexible approach to duration, combined with an active allocation of the duration bets across the different curve segments (slicing duration bets).

Reconciling the short-, medium- and the long-term investment landscape is key for investors to enhance long-term returns while managing the investment path. To achieve this, investors should focus on maximising long-term opportunities (by getting exposure to well-remunerated risk factors and avoiding poorly remunerated ones) while mitigating the downside when the cyclical downturn materialises and keeping in mind that liquidity management will be key.

Different variables affect long-, medium- and short-term dynamics



Key themes to watch



Short and mid-term convictions

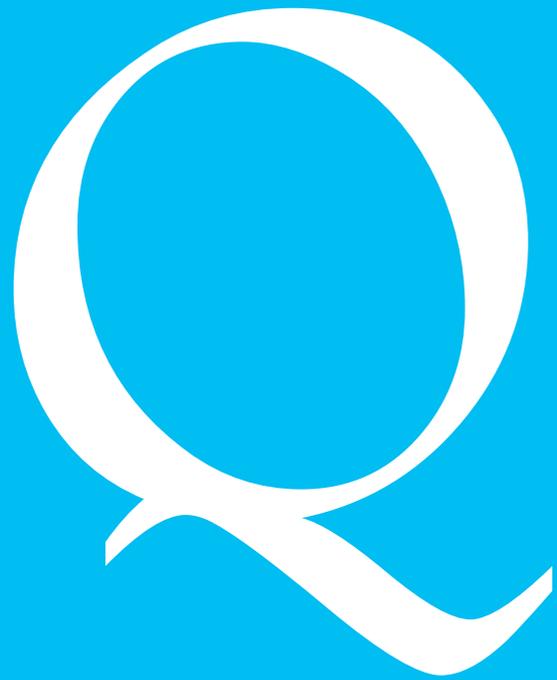
- 1 **Equity:** go global with quality and prepare to switch to value
- 2 **Bonds:** be cautious on duration and actively play the different segments of the curve
- 3 **Portfolio construction:** start risk on, but with an absolute return mindset

Long-term convictions

- Increase upside potential**
- Exploit long-term equity potential with ESG and engagement
 - Capture illiquidity premium in credit and real assets
- Focus on downside mitigation**
- Portfolio construction based on scenario analysis
 - Include structural hedges in the asset allocation

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What are the
key themes for
investors?

Theme 1 - Geopolitical landscape: A multi-polar world in transition is fueling volatility

The geopolitical equilibria continue to evolve towards a multi-polar world. Trade negotiations, oil dynamics and climate policies will be among the key factors driving the redesign of the geopolitical landscape. These trends will be another source of market volatility just when we are seeing monetary policy recalibration.

Geopolitics is increasingly a relevant theme for investors with short- and long-term views. Currently, tensions in the Middle East, political uncertainty in Europe, and trade frictions are all topics under the spotlight in a world of changing global equilibria. The US-China relationship is an example, where the focus is moving to the practices of technology transfers and intellectual property trades. The second open front regards the US and Russia, with the new sanctions and the increasing tensions in Syria and instability in the Middle East. These evolutions reaffirm the emergence of a multi-polar world where EM gain focus and DM risk becoming even more inward looking. On EM, China aims to further increase its economic power and role in international financial markets, and it is now focused on internal reforms. Russia is looking to play a greater role

regarding Europe and the Middle East at a time when Russia is also enjoying an economic recovery and benefiting from a supportive commodity trend. The US currently exhibits a strong internal focus with a priority of delivering on President Trump's electoral promises in light of the upcoming midterm elections, not only from an economic standpoint, but also on the international playing field. Europe is also engaged with internal issues: Brexit and the reshaping of the Union. However, Europe will soon be called upon to play a more global active role, not only in light of its geographical position, but also due to immigration trends and security issues, as highlighted by the Italian elections. With the ongoing redesign of the new global equilibria, investors will need to focus on some key trends: trade dynamics, oil prices and climate change. On trade, tariffs and retaliatory measures could undermine market sentiment and harm global productivity growth and consumption, with significant impacts in both the short and the long run. Higher oil prices are also a key factor to watch, as they will have asymmetric impacts on world economies (threat for Europe) that could drive further divergences. Climate change policies will also be a relevant theme affecting political relationships, with China and Europe increasingly tied up. Given this evolving backdrop, investors should expect volatility to remain higher compared to the past, and currency dynamics to continue to bear most of the adjustment resulting from geopolitical events. Markets will also be affected by the implications that these geopolitical themes could have on growth and monetary policy.

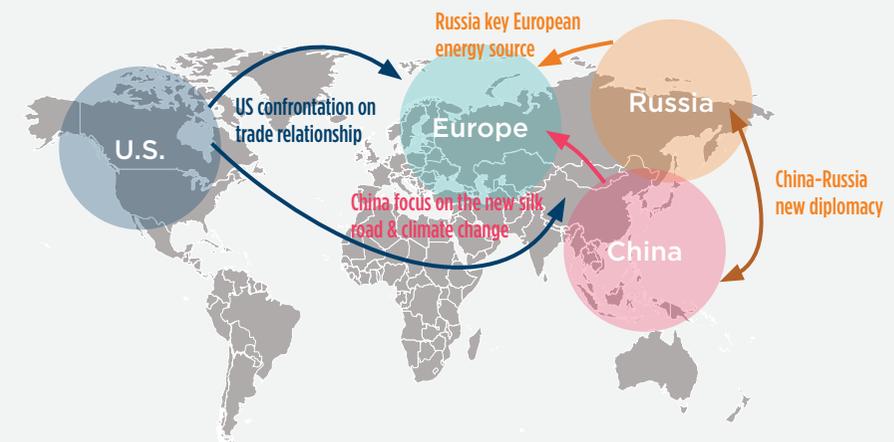
Drawing the geopolitical map in a multi-polar world

Europe inward focus on reshaping the Union after Brexit

- Focus on the redesign of the institutional framework and Brexit deal
- Migration remains the top priority
- Vulnerable to higher oil price
- At the center of various political dynamics with China willing to reinforce the trade relationship and Russia key to deal with the Middle East and Iran

Russia in search of a pivotal role in the Middle East and Asia

- Russia wants to increase its role in the Middle East given also the US exit from the Iran deal
- Russia remains a key energy partner for Europe
- Renewed economic focus on Asia driving a more cooperative stance with China to open up the Russia-China trade corridors



US the global power that puts "America first"

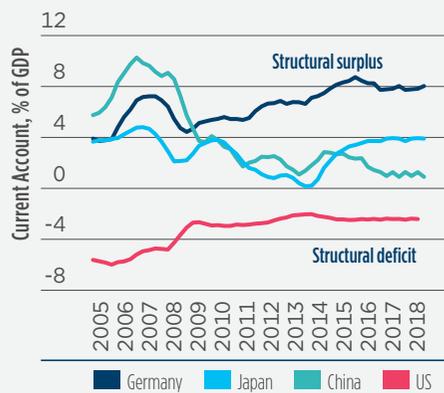
- Global economic and military leader:** no.1 in world GDP & military expenditure (with 24% of nominal GDP share and 36% of global military expenses share in 2017)
- Losing economic power** vs China and running structural trade deficit
- Energy independent** and set to be the world leader in oil production based on the shale revolution
- Domestic focus** driving diminished presence abroad and dis-engagement in key areas

Source: Amundi, IMF, SIPRI, EIA. Data as at May 2018.

China and the rising economic power

- Leader in GDP growth:** China will account for roughly 28% of GDP growth in 2017-22
- Leader in urbanisation, infrastructure initiatives and climate focus** (i.e. US\$1trn "One Belt One Road" initiative)
- Highly trade dependent**, although rebalancing towards internal demand
- Catching up on innovation** with fast increase in expenditure in R&D
- Focus on the long term plan** and required adjustments

Imbalances spur protectionist impulses



Source: Amundi, Bloomberg, IMF. Data as at May 2018.

Theme 2 - Global growth: Still sound but reaching a peak, with divergences at play

We are moving from an acceleration of economic growth towards a deceleration. Some countries may see an extension of the cycle (namely, the US, thanks to the fiscal boost), but overall, the peak of economic growth is behind us. Greater divergences among countries/areas will emerge at the global level.

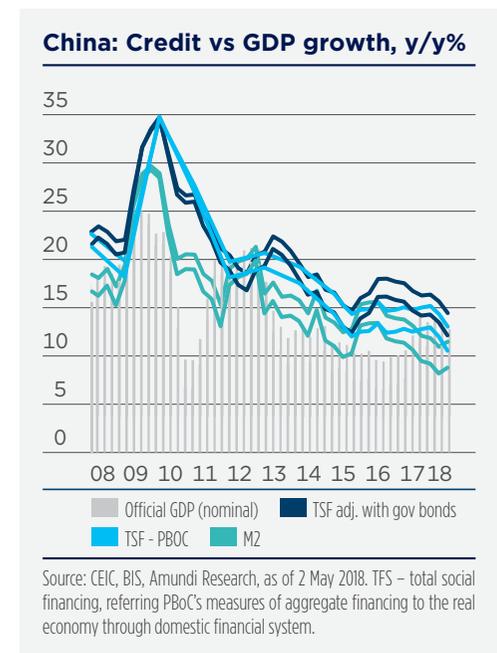
2018 will most likely represent the peak in economic growth, with major DM and EM countries running above potential, but with some signals of deceleration, especially in the Eurozone. We are moving from a phase of acceleration to one of deceleration: the effect of ‘the second derivative’ of growth will matter most regarding markets, even if the global economic picture remains sound in the short term. Based on current conditions, it’s difficult to see an acceleration of growth and corporate earnings at a time when the profit/GDP ratio is at historical highs. While risks related to the political/geopolitical scene are increasing, three key factors could further support a continuation of the positive outlook: the global investment revival, a possible improvement in the European institutional framework, and the resilience in China.

Investment revival

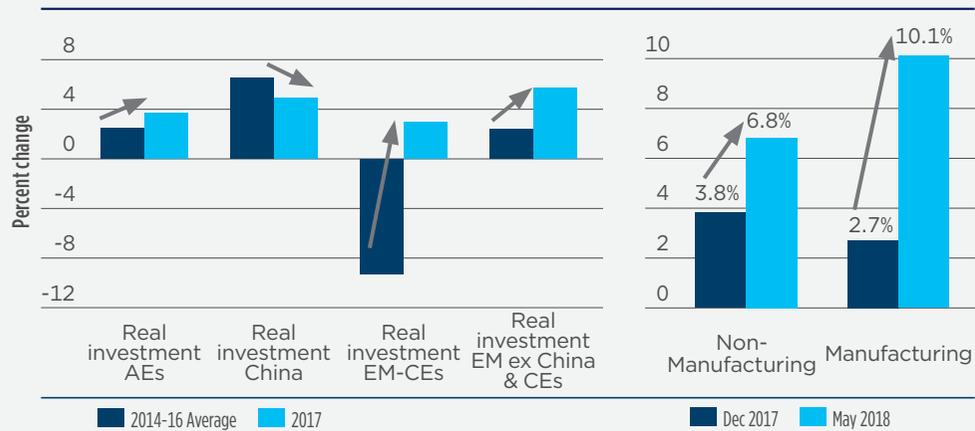
A key contribution to the recent uptick in growth comes from investment spending, especially in DM and some EM commodity exporters. The main exception is China dealing with the transition from being an investment- to a consumer-led economy. Recent data on capex intentions in the US suggest that this dynamic is continuing in 2018, also fueled by the fiscal boost. The US is the only main economy that could see an extension of the cycle. In Europe, the investment outlook is improving, driven by rising capacity utilisation rates, still low financing costs, and a job market that in some areas is becoming tighter. The investment component is expected to represent a positive factor for growth, counterbalancing some possible weakening in global trade.

European institutional framework

Recent data suggest a soft patch in the Eurozone in a context of sound growth. Further economic acceleration could come from a strengthening of the institutional framework and structural reforms. The next 12 months could offer a window of opportunity before the mid-2019 European parliamentary elections, but the most impactful proposals, such as a separate Eurozone budget and common finance ministry, may still prove challenging to achieve. The electoral result in Italy could bring a sense of urgency, as could the US protectionist attitude and Brexit. These elements could be seen as triggers for designing a stronger Eurozone, which would be necessary for the region to play a relevant role in a multi-polar world. Currently, amid political uncertainties in many areas, it is difficult to see material progress or structural reforms further reviving the economic cycle.



Global investment revival may last as capex intentions persist



Source: Amundi analysis on IMF World Economic Outlook, April 2018 and ISM, May 2018. AEs= Advanced economies, EM-CEs= Emerging Markets Commodity Exporters= Angola, Brazil, Ecuador, Nigeria, Russia.

Resilience in China

The Chinese economy is the third element to watch regarding the continuation of the current phase and regarding EM continuing to perform well. Hard landing risk has receded and a smooth deceleration is the most likely scenario: economic growth is relatively resilient to a credit growth slowdown. Leverage ratios are at historical highs, but are falling, with concerns declining about a credit bubble. Private consumption remains solid, contributing to the rebalancing of the economy towards more efficient and less debt-dependent sectors (service and valued added industries).

Base scenario

This backdrop leads to a still supportive short-term macro scenario (growth figures will continue to be good), but with risk of deceleration ahead and little space for further acceleration. We also see the possibility of divergences increasing at regional/country levels where not only geopolitical events, but also monetary policy will have an impact. In fact, the evolution of Central Bank (CB) actions could have important effects on both DM and EM, and will be key factors to watch, together with growth dynamics, in assessing the portfolio risk positioning.

Theme 3 - Central Banks: Divergences and spillovers

Monetary policy is de-synchronised. Looking at the Fed will not be enough: it will be important to look at the overall pool of liquidity. Inflation figures are stable, with some modest upside risk in the US. CB divergences will be a key theme driving fixed income and currencies, with spillover to EM.

Given the positive economic backdrop, CBs are finally exiting their extraordinary accommodative monetary policies. The pace of their moves and their overall stances will be different in terms of speed and measures. CB a-synchronicity will be a key theme to play. What will matter most will be the overall pool of liquidity: for the first time in 10 years, it will shrink in 2019. This new environment could lead to spillover effects driving further adjustments in a feedback loop process that could result in further divergences in monetary policies.

The Fed and the inflation conundrum

The Fed is facing the conundrum of how fast the hiking cycle should evolve, as the fiscal policy could be at risk of overheating an economy already at full employment. The current hiking cycle will progress at an extremely slow pace, mainly due to the inflation pattern which has remained subdued despite the significant economic expansion. Structural disinflationary forces, such as the globalisation in trade of goods and services, e-commerce, digitalisation, and robotics, have been among the causes of the sluggish inflation growth over the last few years. However, looking ahead, inflation risks are tilted to the upside, due to multiple factors (rental price acceleration, consequences of new tariffs, energy prices and wages moving up with unemployment falling below 4%). We expect inflation to accelerate through the year, with only temporary overshooting in mid-2018, and showing higher data due to a base effect. The Fed



therefore needs to find an equilibrium between accepting staying behind the curve to not risk tightening financial conditions too fast vs not letting the economy overheat and having sufficient room for manoeuvre in the future to react to a likely cyclical downturn.

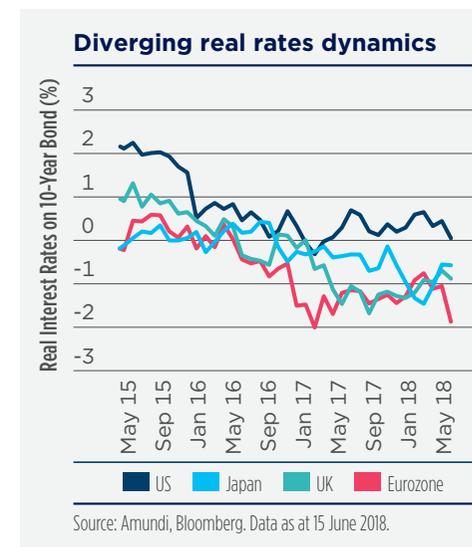
The ECB and the desire to normalise without putting growth at risk

Regarding the ECB, monetary policy evolution looks more dovish. The bank will end its asset purchasing programme at the end of the year and will not start to raise rates before summer 2019. With inflation only recently starting to revive in the Eurozone, the ECB is maintaining highly accommodative monetary conditions. The economic

outlook will also be key. In fact, the potential threats coming from the US policy mix, in addition to the risk arising from higher oil prices and the possible escalation on the trade front bring higher downside risk for growth in Europe (being a net oil importer) compared to the US and could hence justify a further divergence in the monetary stance.

The BOJ and possible changes ahead

The BOJ's stance remains highly accommodative, but the recent debate on "reversal rate" and the mentioning of a potential exit from quantitative easing open the door to possible changes in the CB's policy. However, we do not expect imminent changes, as inflation is still below targets.



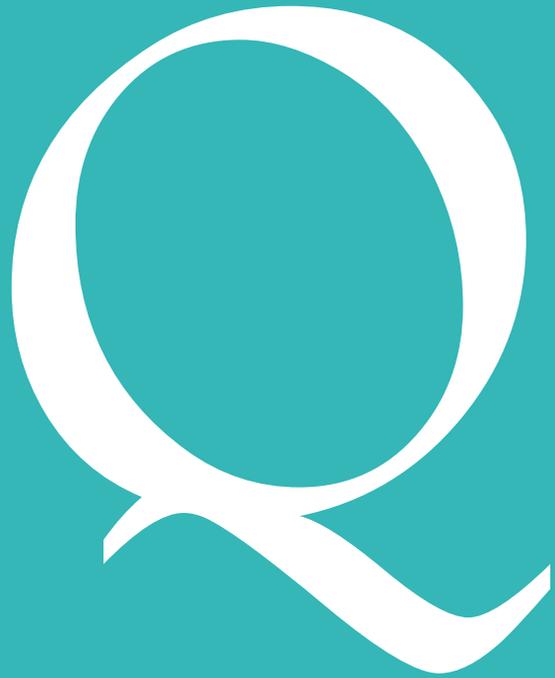
EM currencies volatility on the rise



Spillover effects of policy actions

Currently, the slow pace of the Fed action does not seem to pose a threat for the economic cycle in the US. Risks, instead, could arise more in the EM space, due to the spillover effects of Fed policy. As was recently pointed out also by the BIS, US monetary policy "spillovers are statistically and economically significant for both developed and emerging market economies, and have become relatively larger after the global financial crisis"¹. With some EM more vulnerable to the dollar and Treasury yield dynamics, we are beginning to see more and more idiosyncratic stories materialising in EM (ie. Argentina, Turkey), where geopolitical dynamics are also contributing to increases in volatility, notably on the currency side.

¹Source: BIS Working Papers No 719 "Channels of US monetary policy spillovers to international bond markets", May 2018.

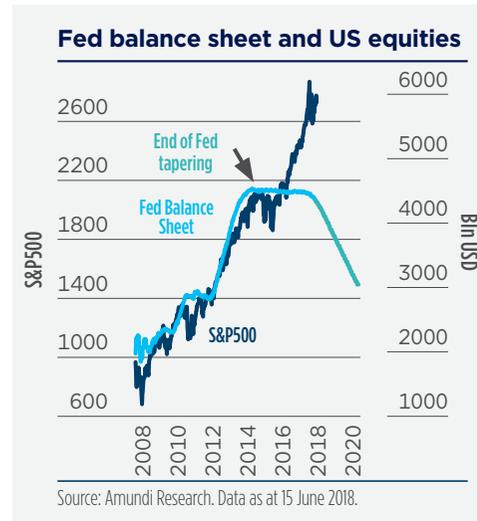


What are the investment convictions for the short and mid-term?

Transition - the end of easy money is leading to volatile markets

A positive bias for risk assets and short duration will leave space for a more conservative risk allocation and a constructive view on duration while we move towards a possible slowdown in the cycle. Higher volatility and lower return potential will require rethinking of investment strategies, with a strong focus on liquidity management.

The three key themes identified are expected to create a more challenging scenario for investors. In the short term, equities remain the favourite focus vs bonds (earnings still sound, low interest rates support higher valuations and risk appetite). However, as liquidity looks set to diminish, support for risk assets may fade. As we move towards the medium term, when a cyclical slowdown will resurface and considering that most of the positive news has already been priced into the market, we are mindful that risks are increasing. For markets, this translates into a new regime of higher volatility. History shows that volatility tended to rise with a lag of approximately two years from the start of a hiking cycle and as 2018 marks the beginning of this move, we should expect to start to see higher volatility, with possible spikes in phases of rising geopolitical concerns.



Consequently, investors should reassess their asset allocation strategy to address this new environment, with a focus on

managing the cyclical component while also being aware of the alternative risk scenarios.

Multi-scenario portfolio construction

From a cyclical perspective, we continue to see opportunities in risk assets, albeit at a lower return level compared to the Goldilocks regime of the last 10 years. We are also aware that alternative scenarios could emerge and trigger asymmetrical gain/loss profiles. To navigate this new environment, investors should rethink portfolio construction across multiple variables: investment time horizon, asset class risk/return potential, correlation expectations, and the potential impact of tail risk events. All these factors should also be constantly monitored, as the emergence of alternative scenarios could have significant implications for all these

assumptions. All in all, and assuming that the current major risks with the potential to trigger negative alternative scenarios (trade war, geopolitical tensions, policy mistakes and inflation surprises in the US) do not result in a full blown crisis, this still warrants a moderate and vigilant bias towards risky assets, coupled with a bias towards short duration, while progressively preparing portfolios for a change in regime. Managing this transition may prove challenging, as in the short term, investors risk moving to a conservative allocation too early (thereby missing upside potential), while risks for the long term could also be rising. In fact, the longer the cycle extends, the higher the likelihood of seeing a very substantial correction later. Hence, liquidity management will be key to tactically recalibrating risk allocation, reducing it in anticipation of a deterioration of the cycle, but also to draw on liquidity as a tool to exploit opportunities. In fact, having a liquidity buffer could allow an investor to take advantage of liquidity events and consequent price dislocations that could offer investing opportunities with higher upside potential. Rotations in equity markets to quality and value will be an area of opportunities to play the evolution towards the next phase, while in bonds, duration management and credit risk reduction will be key. Duration should be short overall in the short term with this bet split and multi-faceted (long duration on US short term, short US long term and Europe). The short duration approach is not for the long term. In cyclical downturns, duration could become long again, unless we move back to a 1970s scenario.

Alternative: back to the 1970s

Inflation becomes the real threat to the economy

Central Banks far behind the curve

Protectionism and/or geopolitical tensions drive inflation higher

- **Bonds:** Ultra-short duration, inflation protection strategies (linkers, floaters)
- **Equities:** Focus on selection to avoid companies with profitability under pressure or over indebted
- **Asset allocation:** Risk asset under pressure, gold and commodities to hedge inflation risk

Base scenario: maturing cycle

Global growth: sound but set to decelerate

Central Banks: divergences and spillovers

Geopolitical landscape: A multi-polar world in transition

- **Bonds:** Be cautious on duration and play relative value, but get ready to adjust
- **Equities:** Go global with quality and prepare to switch to value / defensive
- **Asset allocation:** Time to embrace an absolute return mindset

Alternative: boom & bust as in the 1990s

Global growth driven by increase in leverage/debt

Central Banks loosen policy risk spurring credit growth/market exuberance

Deregulation

- **Bonds:** Be cautious on credit and focus on liquidity
- **Equities:** Reduce allocation and move to the most defensive part of the market
- **Asset allocation:** Focus on hedge against the bubble bust with govies, gold and safe currencies

Source: Amundi CIO Insights, December 2017 "Four investing paradigms for an era of regime shifts".

Equity – go global with quality and prepare to switch to value

It is not yet time to become too defensive on equities, but with higher volatility ahead, a focus on quality companies (with competitive advantages able to withstand the rising global competition and geopolitical uncertainty) and higher geographical and sector diversification is required to navigate towards the next phase of the cycle.

The positive cyclical backdrop is expected to support earnings growth across the board in 2018 and for most of 2019, while the 2020 outlook is more uncertain, based on a likely economic slowdown. This year's February correction marked the end of market complacency and we now acknowledge that a new phase has started. In our view, equities could still post the highest returns among asset classes in 2018 and 2019, but with higher volatility compared to the last five years and with the need to play different themes in the transition towards a more mature phase of the cycle.

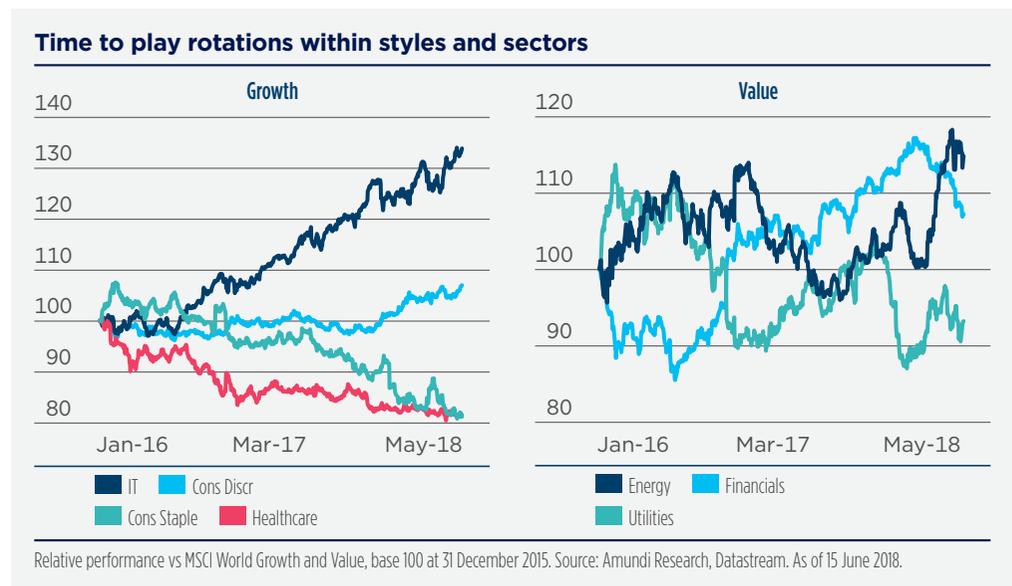
Is the party over in equity?

Yields on US 10Y Treasuries above the 3% threshold, possible peaking in margins

and rising oil prices are all signals of a maturing investment cycle. Yet, the music is still playing, thanks to earnings growth, business investments, and the slow pace of the hiking cycle. In fact, the end of a bull market usually arises after a prolonged period of tightening financial conditions and the approach of a phase of economic contraction, which currently is not in our base scenario. Still, as the cycle matures, investors will need to be careful regarding certain areas of the market where valuations are becoming stretched (growth) and rotate across sectors and themes to extract value. In this phase, yield curve shapes and levels are key factors to watch: a sharp and persistent increase of interest rates could drive a repricing of equity markets and result in a new correction.

Going global with a focus on quality

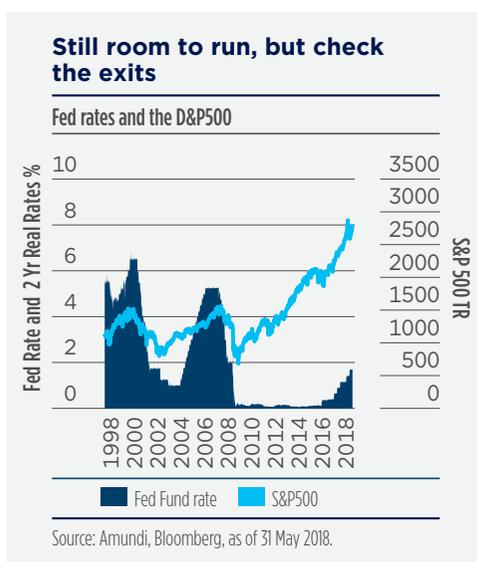
This approach may help investors to exploit different stages of the earnings cycle (US extended thanks to the fiscal policy, Japan likely peaking, Eurozone with moderate room to go). Equity valuations are now more compelling, with some tight areas. With no materialisation of recession fears, cyclicals could continue to outperform defensives. But, as volatility rises and liquidity fades, it is time to balance sector exposure and tactically play sector rotation. A focus on quality companies exhibiting sustainable competitive advantages could also make a difference moving into a late cycle, where micro dynamics could become



more relevant with regard to detecting future winners. While it is too early to switch into deep value at the global level, in our view, the value call will become more relevant in the next quarters as we advance into the late cycle phase. The trigger for a clear turnaround in favour of a full rotation towards defensive stocks should certainly be sought in interest rates, when they hit a ceiling or even start declining again, but we are not yet in this phase. Regional markets may help to get exposure to specific themes: in the US, to the sectors benefiting the most from tax reform and regulation (capex, consumers, banks); in Europe, to value themes, rising rates, M&A and capex; in Japan, to companies posting superior corporate governance.

Emerging market story is not over

In the short term, it may be difficult to delineate EM stories amid higher US rates and a stronger USD. Tighter financial conditions add to rising idiosyncratic risks (mainly geopolitical). In the medium/long term, however, country and stock selection will be key to identifying the winners and losers (in terms of external vulnerabilities, reforms, domestic drivers). The weakness we expect in EM in the coming months, through the summer, due to adjustments to tighter conditions, will, in our opinion, open a window of opportunity to add the asset class to portfolios selectively with a long-term horizon. Our view remains that EM should become a strategic core component of investors' portfolios.



Bonds – cautious (and flexible) on duration, play global themes (CB, EM)

Central banks' normalisation policies call for a cautious approach on duration and higher flexibility in the search for relative value opportunities across regions, curves and sectors. However, looking at the mid-term picture, adding duration will get increasingly relevant to balancing risks in portfolios.

Bond markets are dominating the headlines in 2018, as yields on US 10Y Treasuries are topping the 3% level, which has not been seen since the end of 2013, while the overall curve remains quite flat. Although the upward trend in yields may not have reached a peak yet, a good portion of the hiking cycle could be behind us in the US while this has yet to come in Europe, where negative yields still dominate the short part of the curve. On a mid-term horizon, we see that bond investing is not dead at all: especially as the cycle matures, high-quality and liquid bonds will become even more relevant in asset allocation as a tool to progressively reduce portfolio risk when the cycle does

approach a turning point. This means that capital preservation in bond investing remains key in the short term. But with a mid-term outlook, as yields trend higher and an economic slowdown potentially materialises, new opportunities will arise for bond investors. Our three main convictions for navigating this transition in bonds are:

1. Continue to keep a cautious stance on duration, especially in the Eurozone, but with a flexible approach to adjust positioning as market conditions evolve; go global to play different speeds in CB normalisation.
2. Try to hedge inflation risk, as the expansionary fiscal policies and the rise in oil prices could lead at some point to some inflation surprises, especially in the US.
3. Search for yield theme and move beyond country and sector barriers to cover the full fixed income spectrum.

Still cautious on duration and global relative value opportunities

With rising yields, duration management is at the forefront of investor priorities. Under our base scenario on yields, the 10Y Treasury could continue to rise gently but remain below 3.5% without causing major disruption. Curve positioning can offer opportunities at this stage: in the US, the short end of the curve, for example, is increasingly attractive, as the curve remains very flat (with the differentials in 2-10Y yields at very low levels), while



investors could also exploit cross-curve strategies amid asynchrony in CB actions and idiosyncratic stories.

Inflation: time to consider linkers

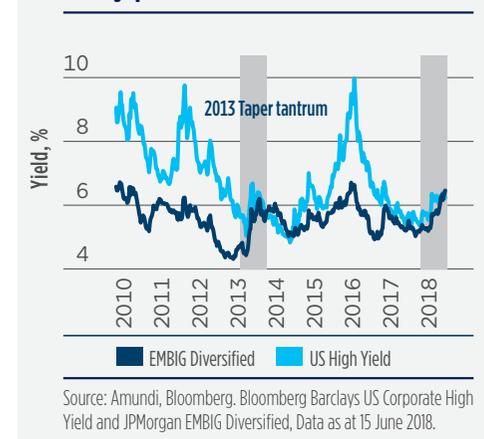
While inflation in the Eurozone continues to be subdued, in the US, the risk is to the upside, at least temporarily. Here, inflation is already moving higher, influenced by many factors, such as housing, transport or medical care. As a result, inflation breakeven has rebounded in 2018, but we think this trend still has room to continue for some time, as we expect a rise in inflation expectations and support from higher oil prices as well. In fact, in our view, inflation is likely to rebound before potentially retracing to more modest growth rates later.

Diversification of income sources

From a cyclical perspective, developed market corporate bonds can still be viewed favourably. But, investors should also prepare for the next phase, when possible tighter financial and liquidity conditions could pose threats for some parts of the credit space, especially highly leveraged High Yield (HY) bonds. Hence, investors should increase diversification in search of income and look for tactical opportunities. In this respect, EM bonds could soon offer some interesting entry levels, given the recent spread widening, which has driven yields on EM IG diversified to the level of US HY for the first time since the 2013 Taper tantrum. As the overall EM bond universe is under pressure due to rising yields and dollar dynamics, selection will be key in the medium term.



EM may offer some interesting entry points



Portfolio construction – time to embrace an absolute return mindset

The emergence of multiple risks, together with the possible mid-term cyclical downturn, requires investors to enhance diversification and focus on downside risk mitigation. This is crucial to building a more favourable risk/return payoff and still capture mid-term upside potential.

The old framework, with highly predictable asset class returns, based on macro variables pointing to a central scenario, is shifting towards a new one with risk factor allocation driven by multiple scenarios. This is changing the portfolio construction approach. As we enter a more volatile market regime, bond/equity correlation dynamics are becoming more unstable. In times of concerns about inflation, markets can experience episodes of simultaneous downside in bonds and equities, resulting in drawdowns that are potentially higher than expected even in balanced portfolios. Looking ahead, we think that building more resilient portfolios will be about the ability to generate asymmetric return profiles by losing less in phases of downturn without sacrificing much

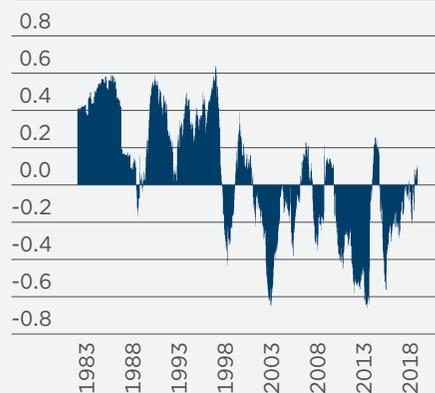
on the upside. Moving from an asset reflation regime, driven by ultra loose monetary policies with market returns far above long-term earnings growth, towards a more mature economic and financial cycle, characterised by tighter financial conditions, higher volatility and potentially lower returns, we think investors should focus on mitigating volatility and possible losses and building resilient portfolios in different scenarios.

Seek uncorrelated sources of returns

To mitigate overall volatility and enhance return potential, investors could consider adding uncorrelated sources of return: for example, including relative value strategies. While markets adjust to a more mature phase of the cycle with no clear direction and possible alternation of risk on/risk off phases, it is more appropriate to exploit relative value opportunities at country/sector/asset levels. Looking ahead, as dispersion dynamics tend to mirror volatility and as multiple divergences could materialise (in growth across countries, in monetary policy among CBs), we expect a more favourable environment for these strategies. Investors willing to add a relative value tilt to their portfolios could also consider absolute return investment strategies that target positive returns with low directionality to the market and a strong focus on downside risk mitigation. These strategies can offer an investment style complementary to traditional asset classes and therefore help to enhance the risk/return profile of a portfolio. Adding absolute return strategies has in the past

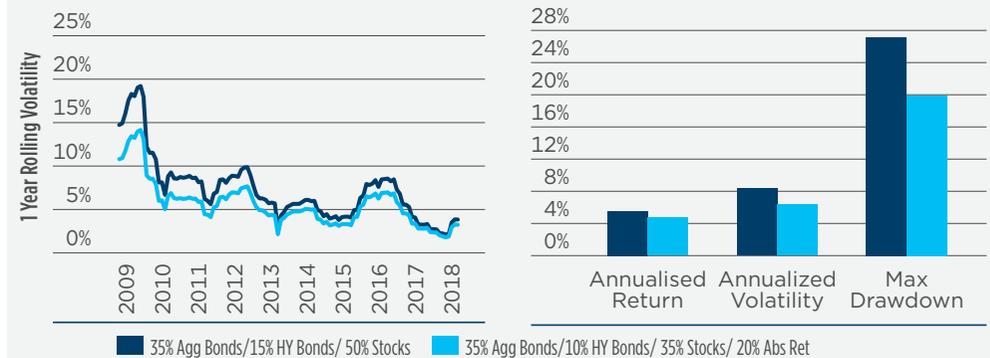
Changing correlation between equity and bond

MSCI World and Bloomberg Barclays US Aggregate bond correlation (1 year rolling)



Source: Amundi analysis on Bloomberg. Data as at 15 June 2018.

Adding absolute return strategies has helped to reduce portfolio volatility and drawdowns



Source: Amundi, Bloomberg. Data since 31 January 2008 to 31 May 2018. Analysis on monthly data. Abs Ret = HFRU Hedge Fund Composite Index. Bonds = Barclays Global Aggregate Bonds Eur Hedged, Equities = MSCI World Eur Hedge Total Return. Other time periods may produce differing results. Past performance does not guarantee future results. This information is for illustrative purposes only and is not meant to represent the performance of any particular investment.

helped investors experience a smoother journey in phases of rising volatility, resulting in a better risk-adjusted performance. Today, investors should be careful in their risk budget allocation and assess the areas of their portfolios that are not sufficiently rewarded for the risk taken and source means of diversifying into absolute return strategies.

Hedging against tail risks

Hedging tail risk events is also a way to mitigate possible losses in a diversified portfolio. Hedging can be implemented via multiple tools. Derivatives, for example, can help to build an asymmetric exposure to the market that can limit or gradually reduce directionality as the market turns bearish. Hedging can also be implemented

through so-called safe haven assets, such as gold or some currencies (JPY, CHF) that tend to benefit in phases of turmoil. The assessment of the probability of an event occurring and its possible impact on the overall portfolio (through stress testing) should drive decisions regarding hedging as well as its cost. In our view, it is valuable to hedge events (with low probability) which may result in relevant portfolio losses, selecting the most cost-effective hedge. In a still-constructive phase for risk assets, but with rising risks, the focus should be on protecting from deep market corrections. When hedging will become too costly and/or risk materialisation more likely, the overall portfolio allocation might be reconsidered, with a move to a more conservative profile.



What should be
the investment
approach for
the long term?

Learning from the past to look into the future: mean reversion matters

Long term, equities tend to post returns in line with earnings growth. Divergences can last for long periods, but due to mean reversion, these phases end up with corrections. In current conditions, markets still have room to go, but unless we see a structural rise in earnings (unlikely), returns should revert to their structural trends.

Long-term investing is about the belief that fundamental value exists and that asset class returns tend to mean revert to their equilibrium levels and rotate around it, within regimes. Hence, looking at long-term historical dynamics may help to put shorter-term asset class returns in context and draw some conclusions regarding the future, in particular on earnings dynamics. In fact, we think that the view on earnings is key to valuations as interest rates will become less supportive.

Lessons from the past

Earnings and equity prices have both risen at a reasonable pace in recent years. To what extent is this sustainable and valid in the long run? We can derive some lessons from the past by looking at the historical relationship between changes in equity prices and in earnings. A starting point for this analysis could

be a research report from the Kansas Fed in 1998 (far left chart below). Why 1998? Because there are common points with the current environment (global and US growth, talks of new tech revolution, bubbling segments in the markets, talks of structural change in the economy, Fed normalisation, etc).

This analysis shows that in the long run (1922-1996) equity prices (S&P500) and earnings have both risen at an annual rate of 8%. However, they have been diverging since 1982, with equity prices rising at an average annual rate of 13%, faster than earnings and above their long-term average.

Additionally, this analysis shows that in the past, these periods of equity prices rising above earnings have lasted 14 years on average and have been followed by periods when equity prices adjusted, rising less than earnings. In fact, reversion

to the mean would imply that periods of above-average returns are followed by periods of below-average returns.

As a result, the subsequent years saw market returns well below earnings growth (middle chart), further depressed by the great financial crisis in 2008, which determined the realignment of the long-term trends in price and earnings growth (at around 7% in the period of 1970-2012). This illustrates how markets actually revert to the mean in the long run.

The current long-term configuration

Today, we are again in a phase of divergence. Since 2012-13, we have seen equity prices rise faster (14%) than earnings (no more than 5%).

Can the market continue to post these returns? With dividend yields of about

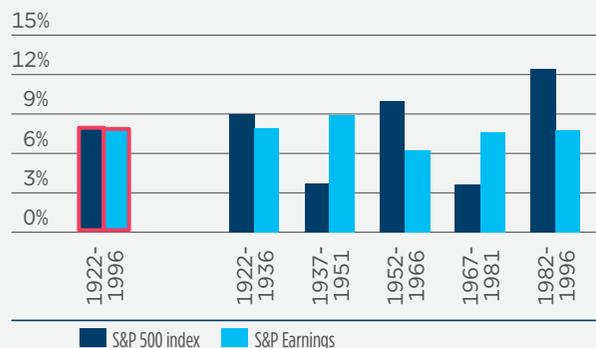
2%, to see a continuation of the trend of the last five years in market returns, return to physical capital should also rise at an annual rate around 12%. This seems unlikely assuming the current trend in labour force growth, stock of capital and productivity, and the high share of profits from value added. In order to return to a phase in which physical capital rises further, productivity gains would have to jump, with all else remaining constant, and this is unlikely at this stage in the cycle.

However, the long-term analysis shows that markets can still go through relatively long periods of divergence and therefore the current phase started in 2012-13 can, in our view, continue for a couple of years, until support from the cycle fades.

A possible correction could, in fact, be triggered by a combination of higher bond yields and downward revisions to earnings expectations.

The long term view back in 1997

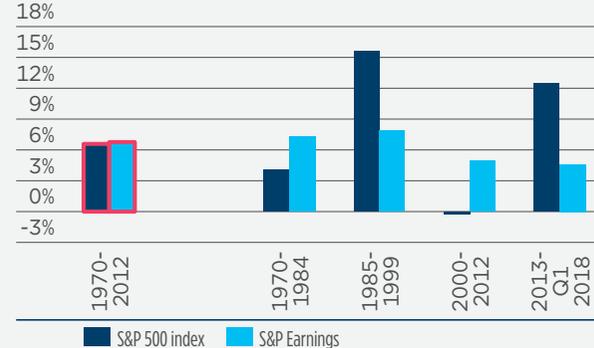
S&P500 and earnings, annualized growth



Source: Federal Reserve Bank of Kansas City (1997).

What has occurred since then

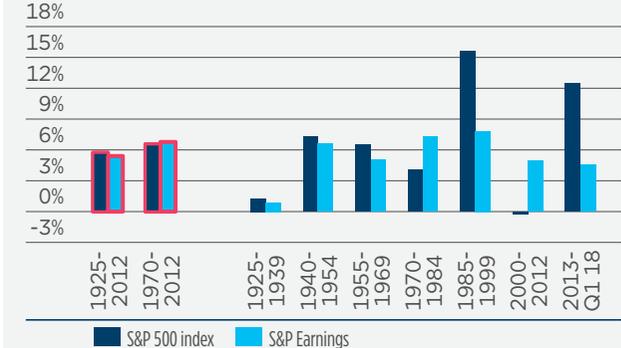
S&P500 and earnings, annualized growth



Source: Amundi Research, Global Financial Data. Quarterly data 1925-2018.

The long term view today

S&P500 and earnings, annualized growth



Source: Amundi Research, Global Financial Data. Quarterly data 1925-2018.

Investment convictions to enhance the return potential in the long run

In entering a long-term phase that will see lower potential returns for a balanced portfolio compared to the past, investors will need to focus on building asymmetric payoff by making more and losing less, and exploiting the long-term risk premium available in the market.

While on equity markets, as we have seen, we expect returns to revert to their long-term mean and therefore to be potentially lower compared to the past 10 years, investors should also be mindful of the long-term trends that will affect fixed income markets.

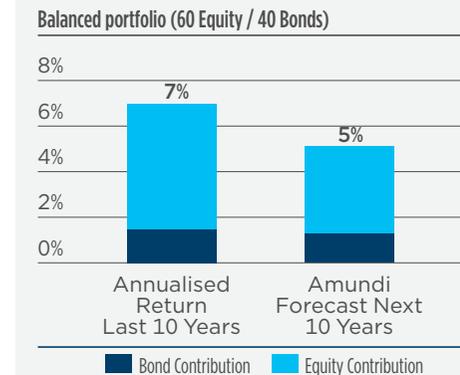
Bonds: low structural interest rates will require an active approach

Over the last 30 years, bonds have enjoyed a long bull run. On top of low (and falling) inflation, on the bond side, the key driver of real returns has been the fall in nominal yields (down from 8.5% at March 1988 to 3.8% at March 2003 to 2.9% at March 2018) which determined significant capital gains over this long benign market phase. Backing this trend, there has been the drop in real interest rates supported by the significant savings flow into DM (savings glut). Looking ahead (ageing population will drive structural demand for safe assets), we expect lower rates at equilibrium which could lead to lower, but still positive long-term real returns (with subdued inflation). With lower government bond returns likely in the future, the ability to generate alpha across the board will be paramount to enhancing total return and income potential for the bond component of a portfolio. Given this goal, investors should exploit market divergences and consider looking beyond boundaries to benefit from the opportunities in the credit continuum (with a strong understanding of each asset liquidity profile).

The need to enhance return potential by including short-/medium-term tactical allocation as well

Lower return potential on government bonds and equities will imply lower returns ahead in a balanced portfolio. To address this challenge, investors will need to focus on strategies that can help maximise long-term results while also mitigating cyclical bear phases. Short- and medium-term convictions can be helpful for identifying investment opportunities in terms of valuable entry points and in managing possible risk scenarios that could undermine the potential to achieve long-term investment objectives. Therefore, the asset allocation should also include structural hedges against tail events and be based on a strong portfolio construction framework to navigate

Facing lower expected returns ahead



Source: Amundi, Bloomberg. Data as at 5 June 2018. Equity: S&P500, Bond: US aggregate Bond.

US Treasury average yields, Real Return and CPI - 15Y rolling



Source: Amundi analysis on data from Global Financial Data, Bloomberg and U.S. Bureau of Labor Statistics. Analysis on rolling real returns (nominal returns – average inflation in the period) on quarterly data from December 1875 to March 2018.

possible different cyclical developments. With possible market downturns in the future, the ability to lose less during corrections can be a valuable source of additional return in the long run.

Widening the investment universe to explore risk and liquidity premia

Expanding the opportunity set to include different regions (ie, EM) will be key, as will

focusing on well remunerated risk factors while avoiding poorly remunerated ones. Real assets should also receive a more prominent role, especially for long-term investors in search of regular cash flows (infrastructure, private debt, real estate) and attractive liquidity premia.

LONG-TERM



SHORT/MEDIUM-TERM



How the investment framework changes based on a long-term view

Long-term investing encompasses a new definition of risk and diversification, a new opportunity set and new investment tools. Based on this new framework, the investment process should be redesigned to exploit long-term potential.

The longer the investment horizon, the higher the degree of uncertainty investors have to deal with and the probability that different scenarios materialise. Dealing with this uncertainty requires a strong focus on the intrinsic value of each asset, based on a strong research framework. But, a long-term investment approach also goes beyond this fundamental assessment and requires a redefinition of all the key portfolio construction variables and a redesign of the investment process.

A new definition of risk

The definition of risk changes significantly with a longer view. For example, when the investment horizon increases, the equity risk (in terms of standard deviation of returns) decreases, making this asset class more appealing on a risk-adjusted basis. A long-term horizon allows a portfolio to weather short-term volatility and, consequently, risk measures should focus on the long term and not on short-term movements. Instead of volatility, these risk metrics may be based on the assessment of the probability and magnitude of tail losses over a multi-year horizon or additionally consider forward-looking risk in probability terms (shortfall risk) of missing the investment goals. Mitigating risk on the basis of these new metrics requires the ability to navigate through periods of turmoil, reassessing investment cases to identify those for which the intrinsic value remains intact vs those that could face the risk of disruption and/or permanent loss.

Diversification across risk factors

Diversification principles also change with the investment horizon. In fact, as correlation dynamics can change over the short term, long-term diversification should be based on the permanent differences in the features of the underlying risk factors (ie, growth, inflation, interest rates, among others).

A wider opportunity set

A longer horizon determines the ability to accept uncertainty on the path of asset price evolution in order to cash in the long-term risk premium. This kind of “pattern-agnostic approach” allows for investment in assets whose performance will, with a high probability, materialise over the long run, but that will remain exposed to uncertainty on the timing and potential price swings during the journey. Therefore, long-term investors can uncover spaces restricted by a short-term horizon, such as illiquid assets (ie, real assets) or distressed assets that by definition require a long holding period. Liquidity management becomes a key tool in this respect, as liquidity buffers can allow for the exploitation of market opportunities when they materialise.

Focus on approaches for the long term (such as active management, ESG, engagement, thematic)

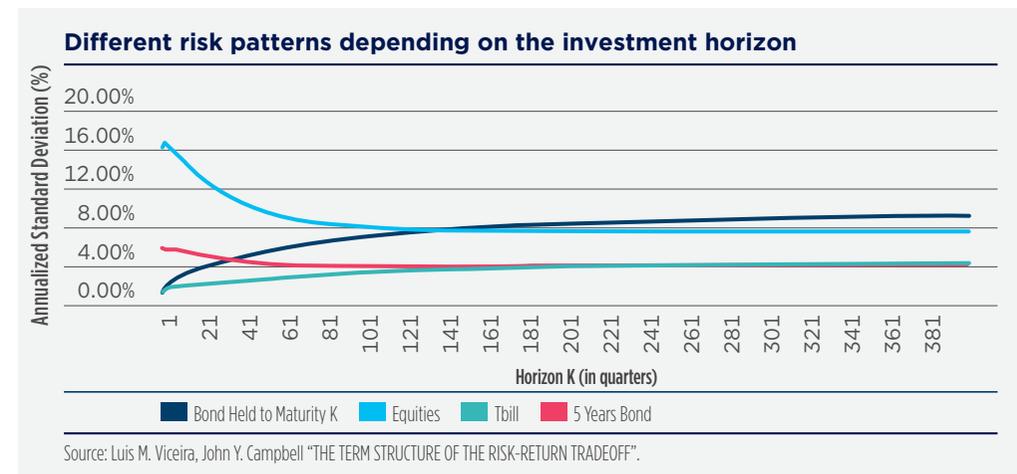
Investment designed to exploit long-term opportunities should be at the core of a portfolio with a long to very long horizon. For example, engaging with companies is

an approach that can help to maximise the long-term value creation, while ESG factors and active management based on fundamental selection are crucial to identifying the intrinsic value of a company, detecting outperformers and avoiding permanent loss of capital. Exploiting long-term thematic investing can also provide the opportunity to benefit from trends that should deliver most of their potential value in the long run while managing risks related to areas of overvaluation that can arise in some fashionable theme.

Rethink the investment process

As we have seen, a long-term approach has profound implications on the definitions of the key metrics underlying the investment process: risk, investment universe and approaches. This implies that the whole investment process should consider this new framework. In this respect, investors could integrate long-term risk

considerations in setting their allocation and implement hedging strategies against such risks. For example, the risk associated with climate change can be reduced via a low-carbon portfolio, without negatively impacting returns. Investors should also set the appropriate split between strategic asset allocation and active management (including tactical asset allocation and security/manager selection) to exploit the long-term risk factors and themes and implement active management where it is most valuable, considering the possible long-term scenarios ahead. The definition of investment objectives with respect to the different time frames is also key, as it allows an investor to bucket the portfolio across investment horizons (with different liquidity profiles) and to benefit from time diversification. In our view, having a proper long-term process and mindset will foster investment behaviours that will increase the probability of reaching long-term goals.



Building investment solutions for the long term

Investing for the long term is both a journey and a destination. These factors require an investor to recognise the themes that will support the most long-term value creation which is not yet priced by the markets. They also require the design of investment solutions for an investment horizon that is continuing to lengthen.

Long-term investing is an approach designed to detect fundamental trends that will drive long-term risk premia and will allow an investor to meet investment goals with a long to very long time horizon. This approach can offer major benefits that can remunerate investor patience, but at the same time, an investor will need to be conscious of the tradeoff vs short-term investing. Taking a long-term view increases the probability of reaching long-term objectives, allows an investor to take a contrarian approach, reduces the risk of being forced to sell and monetise losses, allows for exploration of all possible risk factors, and reduces transaction costs as turnover tends to be lower with a long horizon. Yet, this comes at the cost of potentially experiencing high short-term risk. Furthermore, while many institutional investors, such as pension funds and sovereign-wealth funds, but also retail investors in the early accumulation phase have a long-term horizon, they still usually have additional constraints, such as liability requirements and cash flows that will determine their overall long-term investment strategy. This means that this strategy will need to be tailored around the specific investor horizon, goals and risk guidelines, and will mix long-term convictions with short- and medium-term views as well. Indeed, while the investment goal is set in the long run and hence will require seeking out the trends underpinning the desired future outcome, long-term investing is both a journey and a destination.

The journey will be based on sequences across the cycles, where market valuations and investors dynamics (accumulation/decumulation) matter when deciding on and implementing the path.

Themes affecting long-term investing

The world today reflects the preliminary impacts of some long-term dynamics such as climate change, demographic dynamics, and the growing demand for investment with “purpose” that should be taken into account in framing the investment strategy for the long run.

In fact, all these trends while not yet captured by financial markets could affect asset prices in the long run.

Regulation is also a major topic that could drive further focus on long-term investing, as reflected in some new regulations currently under consultation. For example, the European Union Shareholder Rights Directive recommends asset managers and institutional investors take long-term considerations into account; the UK Department for Work and Pensions also seeks to promote legislation that might require trustees to evaluate how they take account of financially material risks, among which long-term ESG risks were recognised. However, regulations remain ambiguous, as some post-crisis regulations still tend to favour short-termist behaviours: for instance, Solvency II, where capital requirements penalise investments most appropriate for a long-term perspective.

Short- and long-term tradeoff

	Short term	Long term
Risk budget approach	Short-term risk budget runs a high probability to miss the long-term target	Long-term risk budget may imply high short-term risk
Risk free reference	Cash	Depend on investor liability structure
Approach	Pro-cyclical	Contrarian
Turnover	High	Low (Buy & maintain high conviction ideas)
Risk factor exposure	Focus on «priced» risk factors	Focus on full cycle rewarded factors and on «not yet priced» risk factors
Risk of missing investment opportunities/monetise short-term losses	High	Low, but potential risk of over-valuation of fashionable long-term trends

Source: Amundi.

Develop new investment solutions for an expanding investment horizon

The length of the investment horizon is also changing and determining new objectives for investing in the long run. With rising life expectancy, investment horizons are expanding regarding both the accumulation and decumulation phases. Pension reforms and lower interest rates are also leading to the need for investors to take an active role on their investment decisions to address potentially lower pension provisions in the future. This results in the emergence of new needs and new investment solutions. An example of this is the rising demand for solutions designed to take care of the full life cycle, from accumulation to decumulation.

This leads to the emergence of new investor goals moving away from a pure capital appreciation focus in the accumulation phase and income generation during decumulation to more hybrid goals combining capital appreciation with the progressive buildup of an income-generating portfolio for the future decumulation phase.

In our view, the ability to design investment solutions for the long term will rely on a strong alignment between asset managers and asset owners in defining common long-term investment beliefs. This should allow the building of trust and encourage a partnership relationship that will be key to successfully navigating the long-term investment journey.

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Definitions

Alpha - The additional return above the expected return of the beta adjusted return of the market; a positive alpha suggests risk-adjusted value added by the money manager versus the index.

Breakeven Inflation - The difference between the nominal yield on a fixed-rate investment and the real yield on an inflation-linked investment of similar maturity and credit quality.

Correlation - The degree of association between two or more variables; in finance, it is the degree to which assets or asset class prices have moved in relation to each other. Correlation is expressed by a correlation coefficient that ranges from -1 (always move in opposite direction) through 0 (absolutely independent) to 1 (always move in the same direction).

Drawdown - The peak-to-trough decline during a specific record period of an investment, fund or commodity, usually quoted as the percentage between the peak and the trough. Other time periods may produce differing results.

Duration - A measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates, expressed as a number of years. Quantitative easing (QE) is a type of monetary policy used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.

Standard deviation - A measure of return variability (risk) above and below an average rate of return. A higher standard deviation suggests more variability in return over the period.

