Confidence must be earned

Amundi ASSET MANAGEMENT

October 2019

INVESTMENT TALKS

Multi-asset investing: focus on volatility, liquidity and agility

Matteo GERMANO
Head of Multi-Asset,
CIO Italy

- ***A flexible approach is key to deal with a more uncertain world:*** *The increased influence of politics in economic matters and elevated geo(political) risks made it particularly necessary this year to embrace an agile asset allocation approach to benefit from the opportunities that phases of volatility can offer to investors. After starting the year with a cautious stance, we became more constructive on risk assets in January. We then scaled back risk in May amid an increase in uncertainty on the trade front. We are now entering a phase of economic slowdown at a time of very supportive central bank policies that suggests an approach of tactically seeking opportunities in some risk assets while maintaning a strong focus on hedging against possible deterioration of the overall outlook.*
- ***Moving towards 2020, volatility, agility and liquidity are the keywords for multi-asset investors:*** *Accommodative central banks, economic slowdown and geopolitical hotspots will continue to move the market, offering opportunities. However, as the cycle ages and volatility potentially resurfaces, it will be important to keep an effectively diversified approach with some hedges in place. Agility will be key to detecting entry points in the market in order to add some risk exposure in an overall environment that will call for a cautious attitude. Finally, liquidity risk management will be paramount, as possible changes in market sentiment could result in liquidity shortage in some areas.*
- ***ESG will matter even more in the future:*** *ESG risks are increasingly relevant for investors, as they can have material impact on financial assets. As such, assessing the effects of ESG risks on financial assets will become as important as understanding the evolution of the global economy and geopolitics, or company balance sheets.*

2019: AGILITY PROVED REWARDING IN AN EVENTFUL YEAR

This year has been a sharp reminder of how changing dynamics in a globally connected financial system can drive investors to reasses their investment strategies. In 2019, markets had to digest the effects of the trade war, the global economic slowdown (Germany, China and, more recently, broad-based at a global level), and investors' expectations with regard to policy actions.

"The increased influence of politics in economic matters and elevated geo (political) risks highlight the importance of being agile and protecting investors from material downside risks".

The increased influence of politics in economic matters (Trump imposing tariffs and challenging Fed independence) and elevated geo(political) risks (flash political crisis in Italy, pre-elections newsflow in Argentina, Brexit and, more recently, the attack on Saudi Arabia or Turkish action) further highlight **the importance of being agile** in asset allocation to exploit the opportunities that higher volatility can generate. At the same time, it is essential to be mindful of protecting investors from material downside risks.

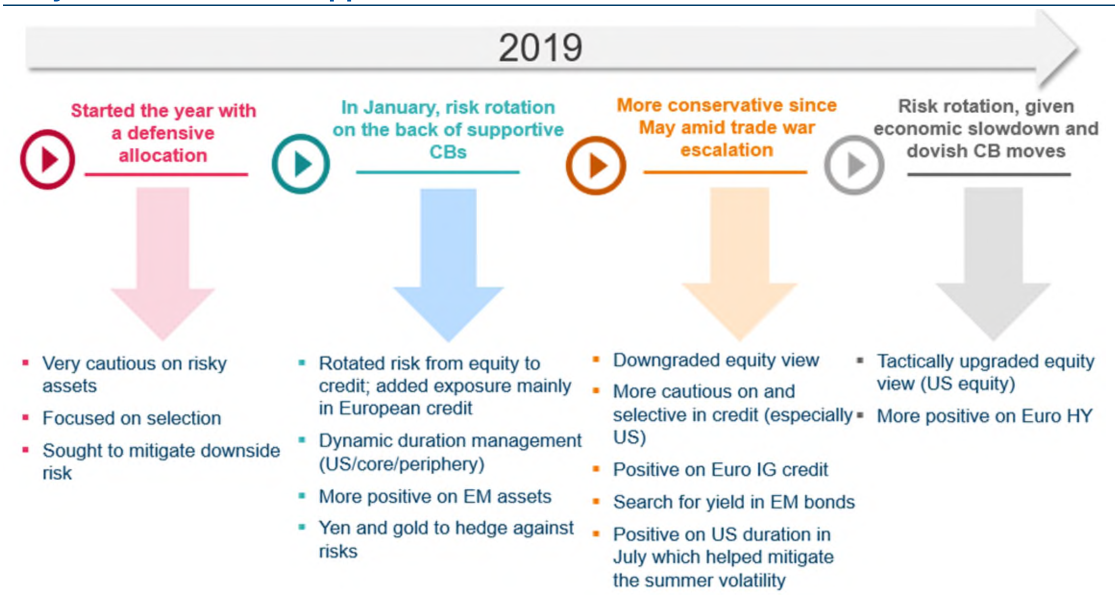
While it was difficult to predict how these events would have unfolded, we started the year with a **defensive risk allocation**, with an aim to limit downside risk and protect investors' portfolios. By the end of January, we became more positive on European credit and EM assets on the back of supportive central banks and accommodative monetary policy.
However, we became **more conservative again around May** and we were cautious on risky assets (particularly developed market equities), given the increasing uncertainty around the trade war, favouring investment-grade credit and EM debt to more volatile equities. The increase of US duration was another way to deal with uncertainly related to geopolitical issues and add protection.

"We started 2019 cautiously and we have revised our asset allocation throughout the year to deal with the economic slowdown and aggressive search for yield induced by CB policies".

Within fixed income, we have been proactively changing our view over the last 12 months. As European bond yields moved into negative territory, **we have been expressing a clear preference for higher-yielding US Treasuries**, both on an outright basis and on a relative value basis compared to German Bunds. We see this view as a good diversifier of our risk exposure which should benefit from slowing global growth, low inflation, and the recent escalation of the trade war. One of the consequences of negative yields in Europe is the intensifying 'hunt for yield'; so again, we have been favouring higher-yielding peripheral bonds, **European investment-grade exposure, and, more recently, Euro high yield**. Technical factors, such as steady inflows and a resumption of the ECB's QE programme, should support European credit markets. Finally, the financial environment appears supportive of EM debt – attractive carry, low US rates, dovish central banks, and subdued inflation are all helpful, although concerns on global trade and growth are headwinds, especially for local currency debt.

In addition, equity allocation has been constantly reviewed during the year. We became very conservative in May on DM equities, and then we slightly upgraded our view on US equity in September. Also, with regard to EM equities, we have taken a more cautious view during the year, preferring relative value opportunities (China and Korea vs the overall market) to a directional view on EM equities.

A dynamic multi-asset approach in 2019



Source: Amundi. Data as of 14 October 2019. CB= Central Banks

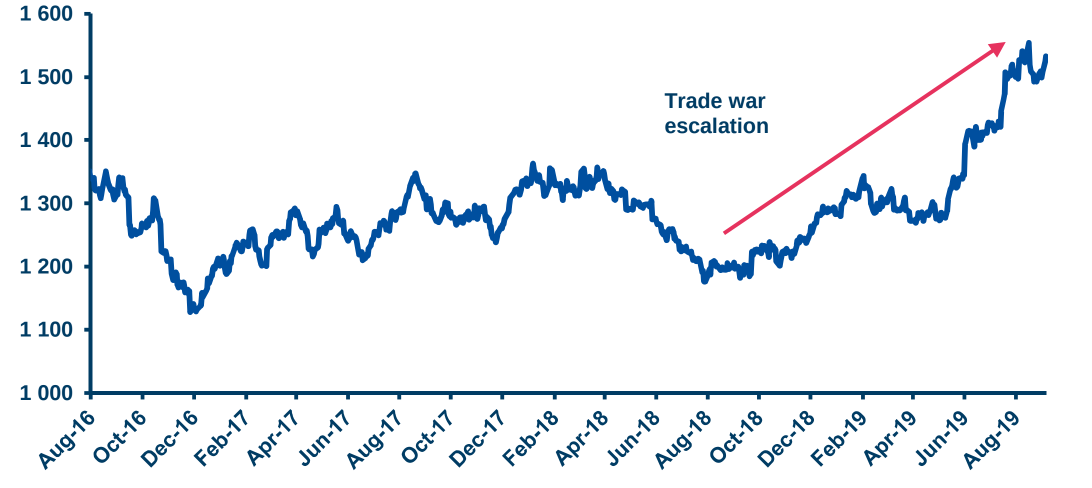
"Contrasting news flow and geopolitical risks may open opportunities, as occurred earlier this year for Italian bonds".

In this environment, a **flexible approach** to investing should remain the focus. Being active also means **exploiting the opportunities that may arise from conflicting and contrasting news flow,** and it is essential that investors stay aware to benefit from the ensuing volatility. **Italian bonds have been a case in point this year**. We were cautious on Italian bonds, due to the previous government's ongoing confrontational approach to the EU amid a weak economic outlook. We then took a more constructive view once the spread between BTPs and Bunds reached interesting and too-high levels, in our view. When the political crisis erupted and it was clear that a new, more pro-Europe government formation was possible, we thought that a large part of the price reduction had already happened in the 10-year segment and that it was appropriate to focus more on the 30-year segment.

"Hedging is more an art than a science: it is important to find a balance between the cost of hedging and the benefit in terms of protection".

Finally, in a world of elevated geopolitical risk, the focus on hedging and protection has to remain very high. It's not that all risks have to be hedged: hedging is costly and there are risks (such as North Korea) that have almost no impact on financial markets. However, it is important to see which risks are worth hedging because they could have material impacts in portfolios, and it is also important to use the appropriate instruments to hedge specific risks. In our view, an exposure to gold, a positive view on US duration and a short exposure to USD/JPY (yen tends to appreciate in market selloff) are all safeguards against increasing tensions on trade talks.

Gold spot price, USD/ounce



Source: Amundi, Bloomberg. Data as of 23 September 2019.

LOOKING FORWARD: HOW TO DEAL WITH A MORE COMPLEX WORLD

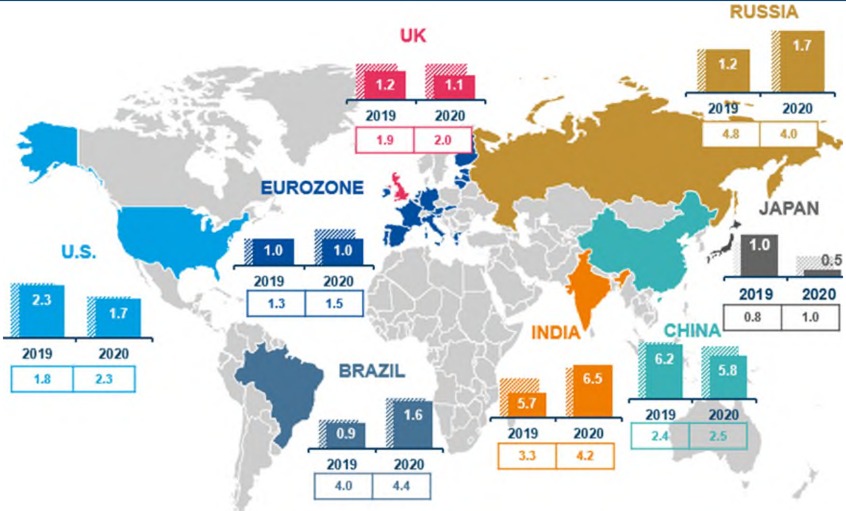
"Accommodative central banks, economic slowdown, and geopolitical hot spots will continue to move the market, offering opportunities".

After many years of bull markets, investors are dealing with the prospect of compressed expected returns in a more complex world.

- **Central banks are expected to continue their accommodative policies**, with the goal being to avoid recession and meet inflation targets. But, their effectiveness on the real economy is progressively fading and a more proactive fiscal policy is needed.
- **Economic slowdown looks set to continue.** Our economic forecasts have been revised down for this and next year, and we see some challenges ahead. Next year will see an election in the US and it is likely that the pressure on global trade will remain high. Global trade growth has been a key driver of global growth in the recent past (average yearly growth of 3.8%), but according to the World Trade Organization, its contribution will be less than one-third this year. If pressures do not ease, this could add risk to the global economy, starting with the most open ones.
- **On the geopolitical front, there are many hot spots.** The recent disengagement of the US administration in Syria and the situation in the Middle East have to be closely watched, as they could have implications regarding oil prices in a phase of deterioration of the economic outlook. On the positive side, a consensus is building around more fiscal policies, in particular in countries such as Germany that have a higher capacity for fiscal stimultation and infrastructure spending, which could support investment and consumption. At the moment, the domestic side of the economy (US and Europe) is resilient, but not completely immune from a deterioration in the overall outlook.

In this environment, some divergences will remain in terms of growth among different countries, with EM possibly rebounding next year.

Growth divergence across the world



Source: Amundi Research; Latest forecasts are as of 8 October 2019. Shaded bars = Previous growth forecasts (real GDP, YoY%), Colour-filled bars = Latest growth forecasts (real GDP, YoY%), Figures in tables = Inflation (CPI, YoY%) forecasts.

"In a more fragile world, it is important to keep a strong focus on portfolio construction and on effective diversification".

VOLATILITY

As we move into the new year, it is important to keep a strong focus on portfolio construction to ensure that we are adding **multiple sources of diversification as volatility may resurface** in a still-uncertain market environment. This will ensure that the overall risk remains in line with client expectations. However, traditional asset allocation approaches, with simple diversification among asset classes, are inadequate for generating reasonable returns. They may expose investors to unwanted risks and therefore are likely to fail to meet investor expectations. This static "asset class diversification" in itself does not necessarily result in what we believe is effective diversification because the correlations that exist between asset classes are inherently unstable and have tended to increase during a crisis. That is why it is important to diversify different risks and sources of returns, and keep a strong focus on hedging.

AGILITY

Maintaining an **agile investment approach**, as has been the case so far this year, will be even more important moving towards 2020. As most of the directional trend in the market is behind us, it will be important to continue to play asset allocation in a flexible way, exploring relative value opportunities linked to regional/sectoral divergences. **The approach will be broadly conservative, in terms of risk allocation, but with a readiness to look for better entry points if increased volatility opens up new opportunities.**

"Multi-asset investors may adopt multiple strategies to deal with the liquidity risk that will remain a key issue next year".

LIQUIDITY

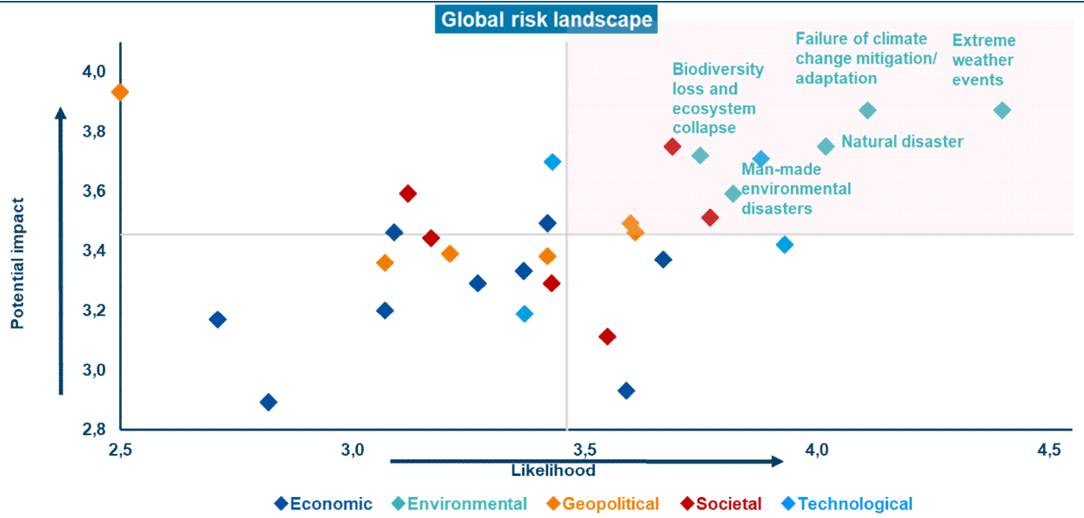
Liquidity management will also be extremely important in this environment. There are increasing concerns around market liquidity and we will need to be vigilant, as we are likely to experience high volatility in the coming quarters, especially if central banks fail to deliver the anticipated rates cuts or disappoint markets. But, there are a **number of measures that a multi-asset investor can take to protect against these liquidity concerns:** first, through effective diversification, in the sense that a material event does not disrupt the overall portfolio and the contagion risk is limited; second, through **active hedging**, meaning that investors are not forced sellers during periods of shock; third, we run regular **"stress-tests"** to assess the potential effects of adverse market movements; and fourth, keeping a liquidity buffer **in cash or short-term government bonds**.

We should also remember that for active managers, volatility can also be seen as a buying opportunity, allowing the chance to add exposure to certain assets at attractive valuations.

ESG AT THE FOREFRONT

We have spoken so far of economic risks linked to the geopolitical landscape, economic slowdown and policy mistakes that may affect investment decisions and market sentiment. These are likely to be very much on investors' radars. But, increasingly, we see other types of risks emerging that could have long-term impacts on investors' portfolios.

Environmental and social factors are the key risks in a globalised world



Source: Amundi elaboration on World Economic Forum Global Risks Perception Survey 2018–2019. Global Risks Perceptions Survey.

"In our view, assessing the material effects of ESG risks on financial assets will become important as much as understanding the evolution of the global economy and geopolitics, or company balance sheets".

Environmental risks – but also societal ones due to growing and high inequalities – are at the top of investors' concerns. Therefore, assessing the material effects of these risks on financial assets will, in our view, become important to the same extent as understanding the evolution of global economics and geopolitics, or company balance sheets.

From our perspective, this will mean evaluating issuers and companies not only on their fundamental factors, such as valuations, earnings growth potential, etc, but also based on ESG factors. Typically, investors believe that the environmental factor is important to evaluate – for instance, to prepare companies for potential regulatory fines on carbon emissions – but the social and governance factors are equally important criteria depending on the sector or industry in which the company operates. For instance, a commercial bank may not have policies focused on the environmental factor, but certainly needs to be evaluated on social and governance factors – from responsible marketing of its products to retail investors to having a strong governance framework for management compensation or anti-corruption policies. Identifying the criteria that are more relevant regarding each industry/sector will therefore be important not only to assess and prevent risk, but also to find mis-priced opportunities.

AMUNDI INVESTMENT INSIGHTS UNIT

The Amundi Investment Insights Unit (AIIU) aims to transform our CIO expertise, and Amundi's overall investment knowledge, into actionable insights and tools tailored around investor needs. In a world where investors are exposed to information from multiple sources we aim to become the partner of choice for the provision of regular, clear, timely, engaging and relevant insights that can help our clients make informed investment decisions.

Discover Amundi investment insights at www.amundi.com

Definitions

- **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).
- **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.
- **Stress-testing:** Stress testing is a computer simulation technique used to test the resilience of investment portfolios against possible future financial situations/shocks
- **Volatility:** a statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.

Important Information

Date of First Use: 14 October 2019.

Chief Editors

Pascal BLANQUÉ
Chief Investment Officer

Vincent MORTIER
Deputy Chief Investment Office