Confidence must be earned

Amundi Pioneer
ASSET MANAGEMENT

February 6, 2018

Volatility Overdue, Economic Growth on Track

Market Update

"Despite the recent market sell-off, it is important to put this bout of volatility into context."

US equity markets lost 6.2% through the first three trading days of February in the wake of a persistent increase in Treasury yields and more recently, stronger-than-expected employment and wage inflation. The rapid downturn in stocks was also related to technical factors, including the rapid deleveraging of funds driven by quantitative models. Despite the recent market sell-off, it is important to put this bout of volatility into context. Year-to-date through February 5, the Standard & Poor's 500® Index was down -0.8%, and over the past 12 months it was up 17.6%.

These outcomes remain consistent with our views that US and global GDP growth remain robust; in particular, the US is benefiting from the recent tax cuts. The 2.9% wage inflation report last Friday, February 3rd, reflects our belief that inflation – on a number of fronts -- may surprise to the upside in 2018, and the Federal Open Market Committee (FOMC) may be behind the curve.

- **FIXED INCOME:** Credit markets have generally held in relative to Treasuries, while the stock market dropped. We believe long-term, fixed income investors should continue to position their portfolios to mitigate the impact of rising rates, and broadly reduce credit risk given extended valuations in a broad range of credit markets.

- **EQUITIES:** From our perspective, this is the time when high-quality stocks selling at reasonable valuations are more likely to provide downside risk management if market volatility continues to rise. This does not necessarily mean that this type of strategy will provide downside risk management in every market decline, especially if the declines are relatively small (i.e. less than 5%) and short in duration. But we believe this can be a sound long-term approach in an environment of continued improvement in economic growth and higher market volatility.

Bond Markets Remain Calm

The 10-year US Treasury has risen from 2.41% to 2.79% since the beginning of the year, including a 0.07% increase in the first three trading days of February. The 5-year US Treasury lost 1.2% and the 10-year lost 3.0% year-to-date. Thus far, credit markets have held up, with US Corporates delivering returns of -0.55% (for an excess return of -0.02%) month-to-date through February 5, and -1.50% (for a 0.70% excess return) year-to-date. High yield markets are down only 0.68% in February, for a year-to-date return of -0.03%. Agency mortgage-backed securities (MBS) saw some duration extension to 5.19 from 4.45 at year end, so that the sector returned -0.29% (-0.05% excess return) in February, and a -1.42% year-to-date return for a -0.17% excess return.

Treasury yields have been driven by expectations of higher GDP growth and higher inflation, resulting from the US tax bill and tightening labor markets pushing up wage growth. Ten-year real yields have risen from 0.48% to 0.69%, while inflation expectations, as expressed in TIPS breakevens, have increased from 1.91% to 2.08%. In particular, markets took note last week of a strong non-farm payroll reading of 200,000, accompanied by a significant increase in wage inflation. Average hourly earnings rose by 2.9% from the prior month's reading of 2.5%, representing the highest increase since June 2009. This strong showing follows on the new nine-year high of the Employment Cost Index in the fourth quarter of 2017, at 2.8% year-over-year.

We Believe Growth Should Continue

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These outcomes remain consistent with our views that growth will remain robust for both the US and globally in 2018, buoyed by easy financial conditions and in particular, continued expansion of global central bank balance sheets (which will remain true for the G4 banks until Q32018), despite the Federal Reserve's (Fed's) tapering program and the European Central Bank's (ECB's) reduction of its purchase program. We believe US GDP growth may increase to almost 3% over the year, benefiting from significant tax cuts, deregulation and stronger fixed investment spending; only protectionist trade policy may temper this outlook. Solid employment and income growth may continue to support consumption and the housing market. Higher corporate profits, benefiting from strong global growth, tax cuts and the 100% expensing of fixed investment, may also support increased fixed investment. Globally, we believe that the Eurozone and Japan may enjoy strong growth, reflecting lower political risk and quantitative easing. While China's growth may moderate in light of its goals to rein in credit growth from the shadow banking system and to improve the environment, we believe a modest decline in China's growth will not disrupt overall Asia or global GDP growth.

In addition, the recent higher-than-expected increase in wage inflation reflects our belief that inflation may surprise to the upside on a number of fronts in 2018, and that the FOMC may be behind the curve in raising rates. Nascent signs of wage growth acceleration, service inflation, tighter labor markets in key industries such as homebuilding, and more restrictive immigration policies may contribute to higher price levels in the coming year. Tax reform has the potential to further fuel inflation. In addition, producer price indices are already increasing, on the heels of higher oil and metals prices.

Focus on Equity Markets

- After more than a year without a 2% correction, equity markets declined last week as interest rates moved sharply higher due concerns that inflation may be rising. Movements in individual stocks were also influenced by quarterly earnings reports, which were generally strong but mixed for some technology stocks.
- The decline was overdue, in our opinion, and consistent with our belief that inflation is likely to increase as the economy reaches full employment, i.e. 0.4% below NAIRU*
- We believe the outlook for equities is positive given accelerating global economic growth and rising corporate earnings.
- However, we also believe that markets will remain volatile, given the prospect for inflation and interest rates will continue to move higher.
- In our view, this environment should favor active managers with a quality bias. Quality stocks typically have resilient business models that can weather changes in economic and interest rates conditions, and they tend to have less debt than their peers.

*NAIRU refers to non-accelerating inflation rate of unemployment.

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