Confidence must be earned

Amundi ASSET MANAGEMENT

February 2020

Investment Talks:

Brexit still weighs on GBP, but the situation on rates and equity could normalise

INVESTMENT TALKS

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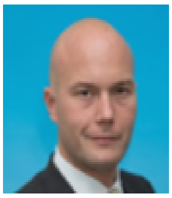

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- ***Next steps and economic fallout***: *Now that the United Kingdom (UK) is officially out of the European Union (EU), a new phase has opened up, during which UK officials will have to negotiate a trade deal with the EU to avoid a 'Brexit cliff edge' by the end of 2020. The available time span is short, but an agreement is possible on either a trade deal, another extension or some mixture of the two. However, there will be renewed moments of doubt related to that 'Brexit cliff edge' before a solution is found.*
- ***Investment implications***: *In **fixed income**, the British 10-year Gilt is expensive, both in absolute terms and compared with other developed markets. We expect the UK yield curve to bear steepen low unemployment and the prospects for increased issuance due to higher fiscal spending. Playing curve movement could be a source of value to fixed income portfolio investors in a low-yield environment. On **FX**, the pound is likely to depreciate in 2020, hit by possible negative news flows on the ongoing negotiations and the dovish Bank of England (BoE) rhetoric. In **equities**, the UK market is cheap compared with its fundamentals and looks attractive in the long run. We see it as a buying opportunity, especially in relation to domestic-oriented stocks, for which the risk/return profile is most attractive.*

What are the next steps in the Brexit process?

The UK officially exited the EU on 31 January 2020. The main topic regarding future UK-EU relations will now be the negotiation of a permanent trade deal – presumably a free-trade agreement (FTA) – to avoid a 'Brexit cliff edge' at the end of the year. During the transition period, the UK retains its access to the EU single market. In the absence of an extension or a trade deal, the UK will lose this access on 1 January 2021 and UK-EU trade would then be regulated only by the World Trade Organization regime. This would cause a significant trade shock, with tariffs and border checks for goods. However, in our view, such an outcome could be avoided for most sectors and an agreement is likely to be found.

What is Amundi's assessment of the upcoming UK-EU negotiations?

"Pragmatism and the preservation of both sides' national interests could lead to an agreement."

Many observers believe that the time available for negotiating a FTA before year-end is too short. While the UK government is stressing that it wants regulatory autonomy, the EU insists that it wants a 'level playing field', which can be interpreted as some form of regulatory harmonisation.

The negotiation will be difficult and both sides will play hardball at the beginning. However, **such negotiations appear simpler than they were back in 2019.** On the UK side, there is now a parliamentary majority and it is therefore unlikely that something is rejected by Parliament. On the EU side, there can no longer be any hope that the UK will remain in the EU, somewhat simplifying the negotiations. Such pragmatism and preservation of both sides' national interests should lead to an agreement so as to avoid or largely mitigate trade shocks. However, there will be further moments of doubt and stress related to the 'Brexit cliff edge' before a solution can be found.

What are the chances of a US-UK trade deal and what is the impact on the EU?

Despite some convergence of tone, style and views between US President Donald Trump and UK PM Boris Johnson, we believe that the US will be tough on the UK when it comes to negotiating a trade deal, with all US industrial lobbies at work. Unlike with the EU negotiation, the two sides do not start from a position of free trade and regulatory alignment. In addition, outside of the EU, the UK does not carry the same weight in negotiations with third parties, be it the United States or other countries. We could see a surprise to the upside, but in our view, **it is unlikely that a US-UK trade deal can be fully negotiated this year**.

How has Amundi's view on the UK economy changed recently and what are the expectations for 2020?

"Our UK GDP forecast has remained unchanged in recent months, at 1.1% for this year and 1.4% for 2021, only very slightly above our figures for the Eurozone."

Our view on the UK economy has not changed much recently, as an orderly Brexit had already been factored into our central scenario. UK growth will be influenced by the remaining Brexit uncertainty and **the sizeable fiscal stimulus announced by the government, worth over 0.5% of GDP, to be confirmed in the March budget**.

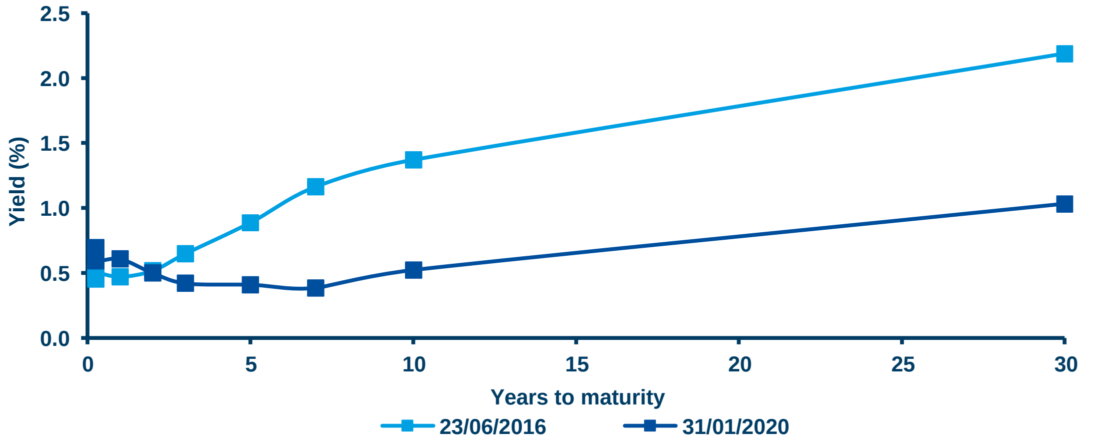
Overall, **our UK GDP forecast has remained unchanged in recent months, at 1.1% for 2020 and 1.4% for 2021, only very slightly above our figures for the Eurozone.** Longer term, we expect Brexit to slightly impair the British growth trend through less vigorous labour market and productivity dynamics. Nonetheless, Britain's potential growth will remain slightly stronger than that of the EU, due to demographics and the fact that the UK remains an economy that is generally friendlier to competition and innovation.

FIXED INCOME AND FX VIEWS

"We expect 10-year yields to rise relative to their two-year equivalents, with the UK yield curve to bear steepen."

Since 2Q19, 10-year Gilt yields have dropped from their post-referendum levels into a range of 0.4% - 0.8%. Valuations of this UK benchmark are expensive, both in absolute terms and compared with other developed markets. In this respect, we expect 10-year yields to rise relative to their two-year equivalents, with the UK yield curve expected to bear steepen. However, recent comments from BoE officials have been dovish and the central bank stands ready to act quickly if the recent boost in sentiment fails to translate into higher spending. Over the next few months, **we expect Gilt yields to rise** as we foresee upside surprises from previously depressed survey data, unemployment remaining low and wage growth stabilising, as well as the prospect of increased issuance because of higher fiscal spending.

UK Gilt curve evolution between Brexit referendum day and the official UK exit

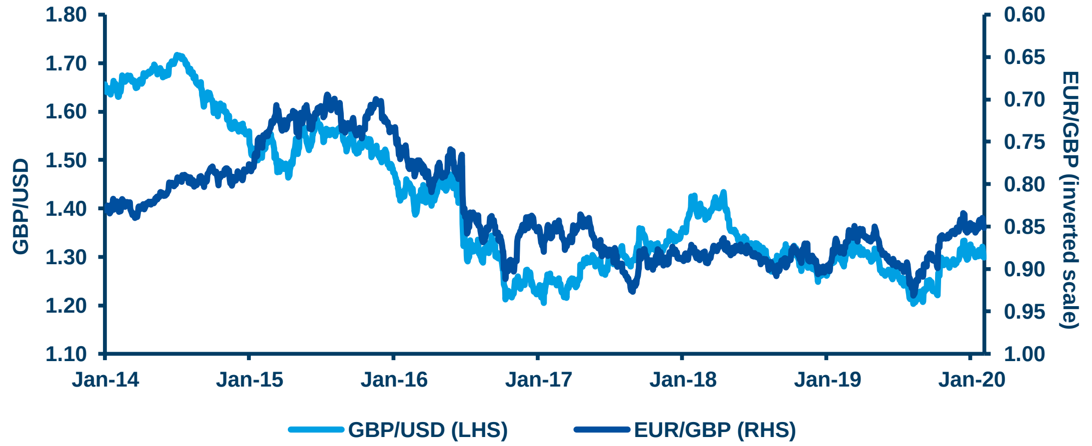


Source: Amundi, Bloomberg. Data as of 5 February 2020.

"Given renewed uncertainty, the UK currency is likely to depreciate in 2020".

Turning to FX markets, since October 2019, the pound sterling (GBP) has moved closer to estimates of fair value, in a range of 1.28 - 1.35 to the US Dollar (USD). **Given the renewed uncertainty, the GBP is likely to depreciate in 2020**. The BoE has pencilled in lower rates as a condition to meeting its growth and inflation targets, while stating a preference for a wait-and-see stance if recent improvements in business confidence do not filter into investment and real wages. In addition, the UK and the EU starting positions on any FTA agreement are far apart and the likelihood of negative news flows on the state of negotiations is high during the year.

GBP vs. USD and EUR: risks are for depreciation of the GPB



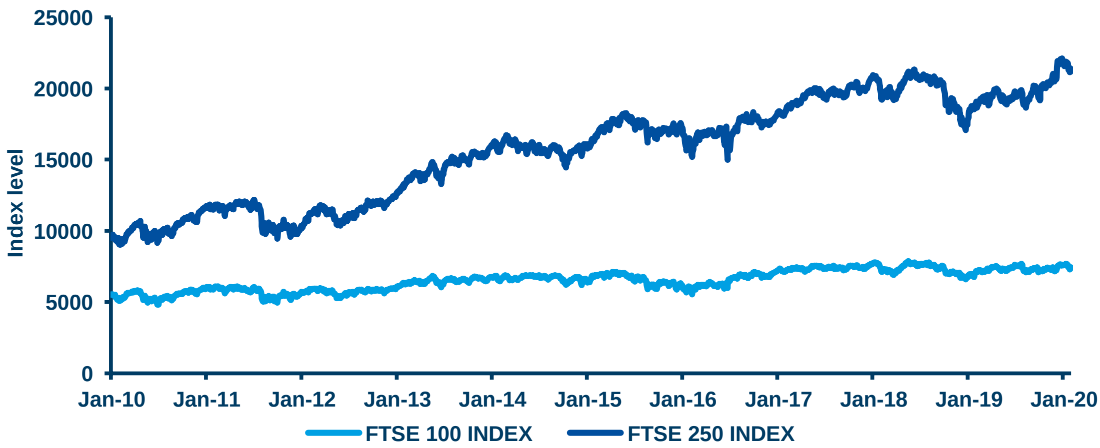
Source: Amundi, Bloomberg. Data as of 4 February 2020.

EQUITY MARKET VIEWS

"In the long term, UK equities look attractive and we see this as an opportunity, especially with domestic stocks."

UK equities are currently cheap. The continued uncertainty as to how Brexit will work out in detail is weighing on stocks, as is the uncertain economic growth outlook. There is a risk that UK equities could remain cheap compared with their fundamentals in the short term, but taking a long-term view, they do look attractive and we see this as an opportunity. Large global companies dominate the FTSE 100 Index, while the mid-to-small cap indices (FTSE 250) are more domestic in nature**. We prefer domestic UK stocks** as this is the area where expectations are low and the risk/return profile is attractive.

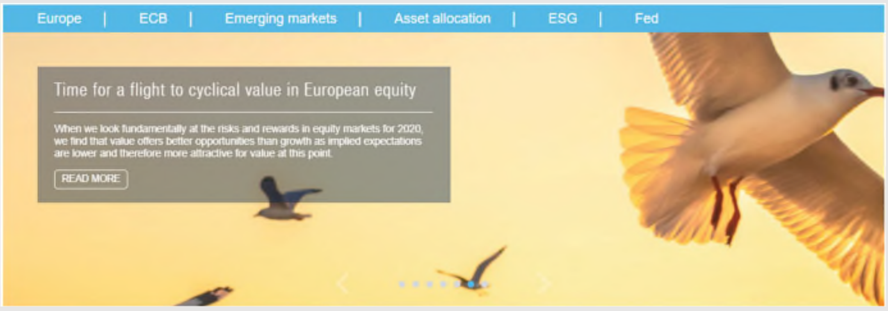
The outperformance of 'domestic' stocks could continue in 2020



Source: Amundi, Bloomberg. Data as of 4 February 2020.

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.



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