CENTRAL & ALTERNATIVE SCENARIOS

Monthly update

We marginally amend the narrative of our central and alternative scenario on the back of recent developments. We also increase the probability of our central scenario from 50 to 60% while reducing the likelihood of the upside scenario from 30 to 20%.

DOWNSIDE SCENARIO 20%

- **Second wave of outbreaks kicks in late 2020**
  - Pandemic expand with slow medical advances
  - National lockdowns measures are restored
- **Economic relapse in 4Q2020 and 1Q2021**
  - Surge of corporate defaults lead to a solvency crisis
  - Persistent high unemployment and rising social tensions
- **Deep and long global recession leads to a depression and a financial crisis.**
- **Monetary and Fiscal policies aren't sufficient enough**
  - Central Banks' constraints by size and liquidity
  - Fiscal responses in Europe happen too late
- **Secular stagnation** comes back to the fore, **debt monetisation** and **de-globalisation are the new paradigm**

CENTRAL SCENARIO 60%

- **Short-term rebound (3Q 2020) from deep short-lived recession 1H 2020)** and convergence to pre-crisis levels with divergences on timing and gaps (2Q 2021 in EMs, by end 2022 in AEs)
  - Pandemic is contained to manageable levels
  - Credit fragmentation and default surge
  - Unemployment slowly correct on the downside
  - Rising fragilities in S-Asia/S. Africa and LATAM)
- **Full debt (new issuance) monetization worldwide with ballooning central banks' balance sheets**
  - Urgency of stimulus fades entering 2021
  - Persistent headwinds (hysteresis effects uncertainty, corporate weakness, precautionary savings).
- **Manufacturing recovers faster than services**, consumption recovery is slow
- **Global trade recovers** but remains sluggish by historical standards. The global cycle is increasingly based on domestic engines
- **Slow recovery**

UPSIDE SCENARIO 20%

- **Economic activity recovers to pre-crisis levels by mid-2021 (US, EZ) with growth moving above its potential in 2H2020 – 1H2021**
  - Pandemic is almost suppressed (treatments, vaccine or natural disappearance)
  - Prompt and pre-emptive stimulus (Europe/ US) / high fiscal multipliers
- **Monetary and fiscal Policy fusion continues** with fast spill-overs to the real economy and financial markets
  - Pent up demand materializes (full mobilization of households forced savings , business investment restarts)
  - Policy aims at productivity increase
- **V shaped economic recovery leading to a strong risk asset momentum**

Assessing the recovery path post Covid-19

The pandemic has altered the picture we had at the end of 2019. Covid-19 has sent us into deep, global economic contraction bottoming out in the end of 2Q2020. A rebound will take place in 3Q2020. Thanks to policy boosters, we will progress into a sequencing recovery with divergences across and within regions. We expect EMs to converge to pre-crisis GDP levels in 2Q2021 while for AEs we have to wait the end of 2022.

In this environment, growth, rates, inflation, monetary and fiscal policies are strongly interconnected. **The potential mismatch of one could affect the overall results**. We expect ultra-accommodative monetary policies to persist, leading to stable and low interest rates worldwide. Strong demand from central banks will cap yields, while the recalibration versus the short end of the curves will ease tensions in the long end. In fact, governments are financing the emergency with short-dated issuance. Central banks' purchasing programs and state guarantees are supporting spreads, in an attempt to safeguard default rates, at least in the short term.

Carry amid low yields is boosting the appeal for credit. Monetary policies are lifting equity markets, but the decoupling from fundamentals is increasing downside risks. We are more cautious than the consensus and we expect EPS to drop and then to bounce back in 2021. The collapse of interest rates differentials and the secular US deficit are building the case for **a bearish USD in the medium term. Be cautious.**

TOP RISKS

Monthly update

Risks are clustered to ease the detection of hedging strategies but they are obviously linked. While we confirm the overall narrative on the outlook, pandemic exacerbated existing fragilities and vulnerabilities while more risks materialized in our radar: financial and geopolitical risks' probabilities are set to creep higher.

ECONOMIC RISK 10%

Depression

- **A Covid-19 second wave** with rising fatalities and restored lockdown measures would weigh on sentiment, increase national and international political tensions and trigger a "W shaped" the economic recovery.
- **A deep and long global recession** where demand remains weak regardless of stimulus packages, and unemployment stays high could undermine mid-term economic prospects. When the sanitary crisis is over, a coordinated response will be more difficult to achieve, leading the global economy to a prolonged stagnation
- **Widespread distress and default rate spikes** will force deleveraging and a pullback on investment and employment, turning the recession into a depression.

+ Cash, linkers, JPY, Gold, USD, Defensives vs. Cyclicals

- Oil, risky assets, AUD CAD or NZD, EM local CCY exporters

FINANCIAL RISK 15%

Financial instability

- **Mounting corporate vulnerability**
  - Prior to the Covid-19 crisis, corporate leverage reached levels above the pre-GFC highs.
  - The magnitude of the recession will increase solvency risks regardless of central banks' actions and government guarantee schemes.
  - Default rates could rise to 15% or even 20% with spill-over on the credit market and stress on banks' balance sheets.
  - Spill over into the banking sector and financial risk exacerbation
- **Sovereign debt crisis**
  - Public debt will rise as a share of GDP across most countries over the coming years, starting from already high levels in Europe, Japan and the United States. This could lead to rating downgrade and rising interest rates over the long term.
  - Emerging markets fragilities (single commodity exporters, tourism), could also face a balance of payment crisis and increase default risks.

+ CHF, JPY, Gold, CDS, optionality, Min Vol

- Oil, risky assets, frontier markets and EM

(GEO)POLITICAL RISK 15%

Covid-19 exacerbates political tensions

- **US-China fissures** are opening up in many areas from covid19 response to trade and technology. The US elections campaign and the hard rhetoric from President Trump could exacerbate tensions negative spill-over effects. Phase 2 deal might be more challenging with a deteriorated economic backdrop.
- **European fragmentation**
  - E.U. member states fail to agree and/or implement the Recovery Plan, eventually undermining the political integration
  - **Or** the Recovery Fund comes too late and its implementation lacks of momentum. This undermines the ECB's position as economic divergences are exacerbated and the EMU becomes unsustainable.
  - Diverging vision about the future of the EU could lead to exit.
  - No-deal Brexit
- **A wave of new trade conflicts** on the back of the Covid-19 crisis and national security interests.

+ DM Govies, cash, gold, linkers, USD, volatility, quality

- Oil, risky assets, EMBI

Methodology

- **Scenarios**

The probabilities reflect the likelihood of financial regimes (central, downside and upside scenario) which are conditioned and defined by our macro-financial forecasts. We use the k-means clustering algorithm to our enlarged macroeconomic dataset, splitting the observations into the K cluster, where K represents most of the variability in the dataset. Observations belong to one cluster or another based on their similarities. The grouping of the observations into the k clusters is obtained by minimizing the sum of squared Euclidean distances between observations and clusters centroids i.e. the reference values for each cluster. The greater the distance, the lower the probability to belong to a given regime. The GIC qualitative overlay is finally applied.

- **Risks**

The probabilities of risks are the outcome of an internal survey. Risks to monitor are clustered in three categories: Economic, Financial and (Geo)politics. While the three categories are interconnected, they have specific epicentres related to their three drivers. The weights (percentages) are the composition of highest impact scenarios derived by the quarterly survey run on the investment floor.

CROSS ASSET DISPATCH: Detecting markets turning points

How to the read turning point assessment

Not reached yet too early to call it | Approaching to the turnaround | Turnaround happened

ECONOMIC BACKDROP

– Global consensus keeps falling but although it may fall further as Q2 data related to the lockdown period become available, economic surprises should mean revert (i.e. start becoming less and less negative) as consensus already corrected significantly. In the US, Economic Surprise Index (Citi) has reached historical highs on the back of positive surprises both on soft and hard data.

FUNDAMENTALS & VALUATION

– **We expect earnings to drop in Q2 and Q3 this year and to bounce back in 2021.**
- In general, potential upside in the central case is not big enough to counterbalance further potential drawdown of the downside risk scenario.
- Valuation: PEs are far from flagging potential entry points in H2 (S&P500's PE @ 17 and Euro Stoxx 600 PE @ 15 2020).

DEFENSIVE ASSET ALLOCATION

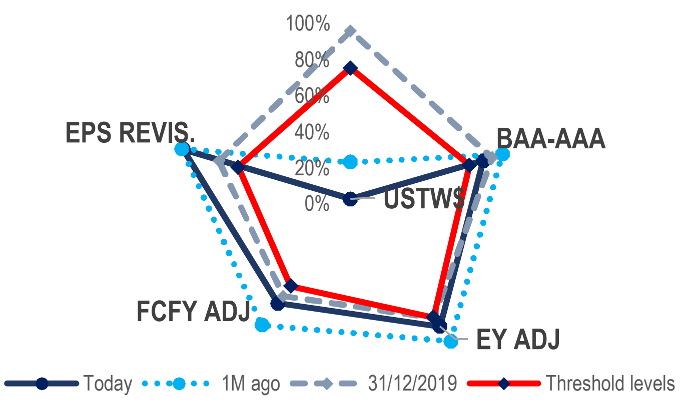
TECHNICALS

– When dealing with tactical signals (ie. Technical factors in addition to pure sentiment indicators) **the picture remains fragile but signs of improvement are visible versus last month.** Technicals proved to move the market since the end of March (Trend following signals kept on suggesting there space for risky assets), but sentiment indicators, which stayed negative since the Covid-19 outbreak, starting to improve less negative at the beginning of June.

SENTIMENT

– Financial conditions eased further on the back of Central Banks' intervention i) Banking System's Health proxies - TED, Libor/OIS, Comm. Papers - back to normal levels and, ii) Corporate Spreads tightened massively. However, **the main change in sentiment relates to our CAST Call, which turn risk supportive on the back of USD** (QoQ) dynamic. From a flows perspective (State Street data) the mood, after being "neutral+" in April and May, moved strongly in RISK ON territory on the back of renewed appetite for high yielders (both corporate and sovereign) and equities lately (Asset Allocation change to equities surged since the beginning of the month).

Cross Asset Sentinels Thresholds (CAST) touching the top



Amundi Research, Data as of 15 June 2020

CAST flags extremely high risk perception.

Sentinels receded from alert levels due to dollar weakening and some relies in financial conditions.

Methodology We consider five inputs which we call "Sentinels": USTW$, Moody's Baa-Aaa, EPS revisions, Earning Yield risk adjusted and Cash Flow yield risk adjusted. These sentinels are used to reposition our tactical asset allocation. Once sound thresholds are detected, the five variables are aggregated as an indicator that anticipates the market's stress conditions, with a certain level of conviction. The pentagon visualises the five sentinels where the red line represents the alert threshold. The greater the distance above the red line, the higher the risk perception, and eventually the need to move closer to a defensive asset allocation.

GLOBAL RESEARCH CLIPS

1 EUR

The appetite for EUR/USD has been rising too fast and too far. We confirm our 1.07/1.10 short-term target and our 1.14 medium-term target.

- Support for a stronger EUR since May has been driven by: (1) lower political risk perception (EU Commission's proposal of a Recovery Fund; lack of strong response by the US towards the China New Security Law in HK, and a commitment on both sides to keep the Phase One Deal alive); and (2) the rebalancing the growth premium towards the Rest of the World thanks to revamping fiscal expansion.
- Although we acknowledge EUR tail risk has fallen substantially, we remain of the view that **the current movement has overshot some short-term drivers.** Moreover, the **differential in EPS 12M growth expectation has continued favouring the US, and physical commodities (our preferred proxy for growth) haven't bounced back consistently**. We prefer EUR vs. GBP (while hedging Brexit risk) and expect a correction vs the USD.
- Financial conditions have eased but they remain fragile. We are struggling to see banks, which have been provided with ample USD liquidity (TED, LIBOR-OIS Spreads are back to normal levels) circulating it to the system. FX will continue to be the asset class pricing in this risk and supporting USD.

2 inflation

We expect short-term *low-inflation*, if not disinflation, risk. Then higher mid- to long-term inflation is likely, but hyperinflation isn't.

- A negative output gap and slack in the labour markets will overcome short-lived price spikes on selected items or the oil basis effect. ECB has a 0.9% target for 2022
- Debt overhangs amid prosecution of monetary and fiscal monetary fusion might lead to higher inflation rates in the medium to long terms.
- Central banks will be managing price dynamics systematically to avoid secular stagnation, in case real rates do not decline sufficiently to balance private sector savings and investment. CBs might possibly revise their mandates and allow temporary overshoots to avoid premature tightening.

3 Potential market catalysts

(+) A positive combination of falling virus cases, rising PMIs, and continuous policy support leading to rising growth expectations

(+) Consolidation of commitment and political capital in the Eurozone, with the European Council approving the EU Recovery Plan

(+) US labour market improvement

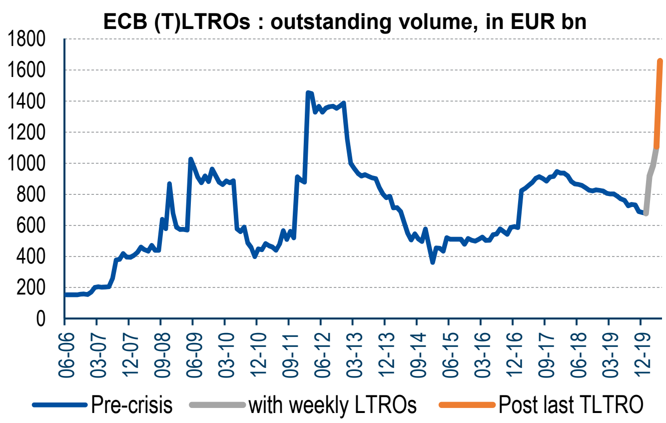
(+/-) US elections in November, year-end Brexit deadline

(-) Widening gap between China and EM

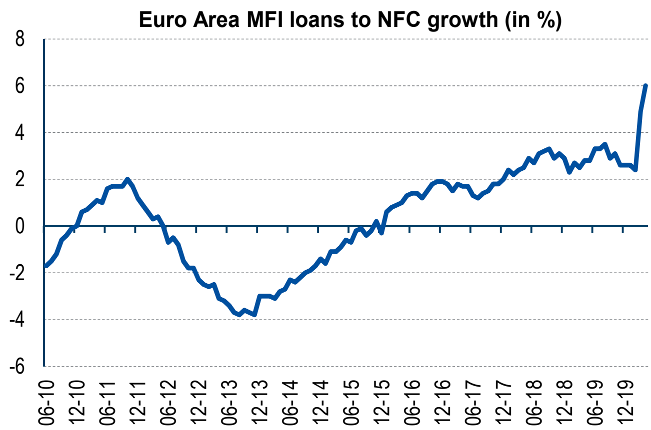
(-) German Constitutional Court's early-August deadline for the ECB's PSPP proportionality assessment

TLTRO: positive for spreads and supporting real economy

The ECB's TLTRO successfully added net €550bn of liquidity, on top of the €400bn already injected since March through weekly LTROs. Since the outbreak of the covid-19 crisis, almost a €1t of additional liquidity has been injected thanks to long-term financing. The high take- up represents a positive test for the effectiveness of monetary and fiscal policy in supporting SMEs and easing financial conditions.



Source: Bloomberg, Amundi Research. Data as of June 2020



Source: Bloomberg, Amundi Research. Data as of April 2020

AMUNDI ASSET CLASS VIEWS

	Asset Class	View	1M change	Rationale
EQUITY PLATFORM	US	-/=		The US market was a core holding in the 2009-2019 cycle. There is room for more cyclical markets to catch up, but US elections could bring uncertainty in the form of a potential victory for the Democrats (in both houses). That could potentially lead to changes in regulations and taxation policy. However, the huge liquidity being fueled into markets is here to stay, as are low interest rates, which may again support quality stocks, which make up a large portion of the US market. The US market is concentrated in a few large stocks and valuations tend to be better outside this concentration.
EQUITY PLATFORM	Europe	-/=		Europe has suffered during the past cycle. Two factors have revived international interest: the Recovery Fund plan, should it be confirmed, and the cyclical/value catch up. This revival has further to go. The risk is that if Europe is a value play, financials and energy – which are value sectors – are also disrupted sectors, which might limit their outperformance.
EQUITY PLATFORM	Japan	=		Japan experienced ups and downs in the previous cycle. Being one of the most cyclical markets in the world, it is benefiting from the current cyclical catch-up. Should it be confirmed, it could benefit for the remainder of the year.
EQUITY PLATFORM	Emerging markets	=		Globally, EMs have underperformed since 2011, except for the 2016-18 period. They could catch up, should the USD confirm a breakdown. Asia is potentially safer, given, among other factors, its exposure to technology, but US-China tensions and geopolitical risks (North Korea) could be a drag.
FIXED INCOME PLATFORM	US govies	=/+		From a global portfolio perspective, we maintain our preference for US Treasuries duration vs. other DMs, on better absolute and relative valuations and the Fed having more leeway available through unlimited QE. We expect the Fed to absorb most net additional issuance of US Treasuries over the next months. In US portfolios, we are cautious on USTs amid the rising fiscal deficit and the unprecedented fiscal support plans.
FIXED INCOME PLATFORM	US IG Corporate	=/+		Despite recent tightening, US IG spreads still offer attractive absolute and relative valuations. Primary market activity is high, benefiting from the search for yield and investment flows, while the Fed will keep supporting the demand for this asset class thanks to its QE programme. Selectivity is increasingly relevant in a weak macro and microeconomic environment.
FIXED INCOME PLATFORM	US HY Corporate	-/=	▲	HY should remain supported by recent backstop announcements from CBs. The valuations of US HY spreads look tighter than those in other credit markets. For this reason, together with liquidity issues, we favour high-quality versus low-rated names, as the latter discount only partially the rising default risk. Sector and issuer selection remains key.
FIXED INCOME PLATFORM	European govies	-/=		We are cautious on core European government bonds but slightly constructive on the peripheral countries after the ECB's recent expansion and extension of its PEPP, and the encouraging steps on the EU fiscal front. Core curves should remain stable, close to current yield levels. However, we still need concrete implementation details of the Recovery Fund.
FIXED INCOME PLATFORM	Euro IG Corporate	++		We are positive on Euro IG, particularly on BBB-rated debt and financials. The ECB will support the technicals of this asset class directly through CSPP and PEPP and indirectly as they push investors to hunt for yield. Among different credit markets, valuations look attractive, while fundamentals tend to show a lower financial leverage than in the US. However, selection remains key.
FIXED INCOME PLATFORM	Euro HY Corporate	=	▲	In EU HY default rates should rise less than in the US, thanks to the higher average credit quality and the lower exposure to the distressed energy sector. We prefer high-quality and more liquid BB-rated debt on the back of an attractive risk-return profile. A focus on selection, idiosyncratic risks and liquidity is extremely important.
FIXED INCOME PLATFORM	EM Bonds HC	=/+		We are cautious on EM debt but favour HC over LC. In the former, we see room for further spread compression between HY and IG and believe valuations are attractive in HY. The support from the USD strength should remain in the short term. However, the risk of sovereign default has to be monitored carefully.
FIXED INCOME PLATFORM	EM Bonds LC	=		We are neutral on LC and believe there is more scope for selectivity in this asset class. We are still prudent — but slightly more constructive — on the EM FX side. It is important to consider the US election risk.
OTHER	Commodities			The outlook is moderately positive for commodities, assuming a global recovery. WTI oil should move in the $/b 30-40 range, while dovish CBs and low real rates will support gold. Geopolitical tensions related to the US-China dispute should inflate some volatility within base metals as we approach the US elections.
OTHER	Currencies			As most countries ease lockdown measures and with the prompt policy intervention, USD will lose ground as we move into 2021. The reduction of the rates advantage and the expectations of a global growth rebound will reduce the appeal of US assets. The path will not be linear, as the short-term picture remains gloomy and liquidity does not necessarily translate into higher solvency.

LEGEND

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Negative | Neutral | Positive | Downgrade vs previous month | Upgraded vs previous month

Source: Amundi, as of 18 June 2020, views relative to a EUR-based investor. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research, investment advice or a recommendation regarding any fund or any security in particular. This information is strictly for illustrative and educational purposes and is subject to change. This information does not represent the actual current, past or future asset allocation or portfolio of any Amundi product.
IG = Investment grade corporate bonds, HY = High Yield Corporate; EM Bonds HC / LC = EM bonds hard currency / local currency. WTI= West Texas Intermediate. QE=quantitative easing.

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