CENTRAL & ALTERNATIVE SCENARIOS

Monthly update

We maintain the overall pandemic narrative confirming the probabilities, assigned to the base and alternative scenarios.

DOWNSIDE SCENARIO L shaped

20%

- **Pandemic extended up to mid-2021,** with slow medical advances and a second round of outbreaks late 2020
- **National lockdowns measure are extended** as fatalities increase
- **Deep and long global recession leads to a depression**. Demand and economic activity collapse, even beyond the direct impact of the public health emergency
- **Full debt monetisation** worldwide with ballooning public debts and rising CB balance sheets
- **Loss of potential output** on collapsing businesses
- Long period of **financial repression** (through regulation and zero-interest-rate policies)
- **Massive bankruptcies and mounting costs of collapsing businesses** undermine confidence in the banking sector and lead to financial instability
- **Secular stagnation** comes back to the fore and **de-globalisation is the new norm**

CENTRAL SCENARIO Base shaped

50%

- Temporary but prolonged shock:
  - **the pandemic is not over end 2Q20** (falling death rate, but the disease doesn't disappear)
  - national **lockdowns are limited in time**, the epidemic is finally under control in Q3
  - health and economic crises in vulnerable emerging markets (Africa and South Asia)
- **Global deep recession in Q1, Q2 and Q3 2020** with different speed and intensity across regions, higher levels of unemployment
- **Slow sequencing recovery beginning in 4Q20** (hysteresis effects and sluggish growth), followed by a **rebound in 2021** (mostly driven by the base effect and stimulus packages)
- Governments and CBs "**Bazooka" policies** calm animal spirits (fear factor) in the short run (Q2) and **preserve incomes and businesses** (amid regional differences)
- **Corporate defaults surge in 2020** with tighter financing conditions and declining profits, coupled with the oil-price fall. Deep fragmentation of credit markets and solvency issues that will exacerbate in 2021
- The **reversal in the manufacturing sector lags the reversal in services**
- **The Chinese recovery** is curbed by weaker demand from the RoW
- Some stagflationary forces materialise **(de-globalisation)**

UPSIDE SCENARIO U shaped

30%

- **Time-limited shock, the pandemic** is under control in 2Q20
- **Deep but short-lived recession** mainly in 1H2020 with unemployment recovering fast
- Global central banks and fiscal **coordinated actions** support the restart of the economy which heads back to its pre-crisis level already in 2021
- **Reversal** of the manufacturing sector and services
- **Limited number of corporate defaults** thanks for government supports and central bank liquidity measures
- Pent-up demand materialises
- **Above potential growth in 2021**, and possibly in some countries as early as 2H2020

Where do we stand on Covid-19

China has declared it won the battle against Covid-19 and its economy seems to be back on track. Though a second wave is still possible, China, Japan and other Asian countries have successfully managed new clusters so far. **Lockdown measures are gradually lifted across Europe and the US** while the rate of daily deaths of patients diagnosed with the virus continues to ease.

As we are writing, around 5,5 million people have been infected and 350 thousand died according to official numbers with a third coming from the US. Brazil where hospital are overwhelmed and Russia account for more than 350 thousand cases each with a relatively low death rate. However, statistics are getting less and less reliable as the virus is spreading across emerging countries.

Although the chance of finding an appropriate drug or a vaccine is rising, since several medical studies are showing encouraging results, there is still no treatment to the disease. Therefore, social distancing, partial or complete confinement, and availability of masks, tests and hand sanitizer are the main factors to contain the outbreak. Frontiers remain shut for the most part including within the E.U. Schengen area, and advanced countries are competing for medical equipment, drugs and a potential vaccine. Inequality of access to a vaccine will probably be a **source of geopolitical tensions** going forward.

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%
Probability

Depression

- The **European Recovery Fund** comes too late and its implementation lacks of momentum. This undermines the ECB's position as economic divergences are exacerbated.
- The pandemic continues with a second outbreak and rising fatalities, leading to restated lockdown measures
- **A deep, long global recession:** demand remains subdued as unemployment stays historically high
- **Unsustainable debt burden** post emergency crisis responses, leading to a sovereign debt crisis
- **Rising default risk** and exacerbated emerging markets fragilities (single commodity exporters, tourism)

+ Cash, linkers, USD, Defensives vs. Cyclicals

- Oil, risky assets, FX commodity, EM local CCY exporters

FINANCIAL RISK

15%
Probability

Financial instability

- **Mounting corporate vulnerability,** solvency issues, and increase of default risks (>15 or even 20%)
- **Spill over into the banking sector** and financial risk exacerbation with a large number of defaults due to global recession and financial instability
- **Central bank policies inefficacy**: UST long-term bond yields to rise despite the Fed's QE with low pick-up in the primary markets (the same may occur in euro area)
- **Rating downgrades, Balance of Payment crisis and credit default** as a result of excessive policy easing on existing fiscal and external vulnerabilities

+ CHF/AUD, YEN (AUD, NZD, CAD), CDS, optionality, Min Vol

- Oil, risky assets, frontier markets and capital outflows

(GEO)POLITICAL RISK

15%
Probability

Covid-19 exacerbates political tensions

- **US-China fissures** are opening up in many areas from covid19 response to trade and technology
- **E.U. fail** to agree and/or implement the Recovery Plan, eventually undermining political integration
- **US elections:** A more aggressive campaign rhetoric weighing on market. The outcome of the elections bring political gridlocks.
- **Economic and national security interests** (and objectives) arising from a revival in the coronavirus, lead to a new wave of trade conflicts
- The UK is moving to **hard Brexit**

+ 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

— **The global consensus has reached new lows, even beyond the levels of the GFC; global economic surprises as measured by the Citi ESI seem to have begun some reversion.**
— The consensus may correct even lower as a new stream of negative data could come out the next few weeks, but the correction that has already happened in many countries may leave some room for positive economic surprises, given the very low and pessimistic expectations.

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 the potential further drawdown of the downside risk scenario.
- Valuation: PEs are far from flagging potential entry points (S&P500's PE @ 17 and Euro Stoxx 600 PE @ 15 2020).

DEFENSIVE ASSET ALLOCATION

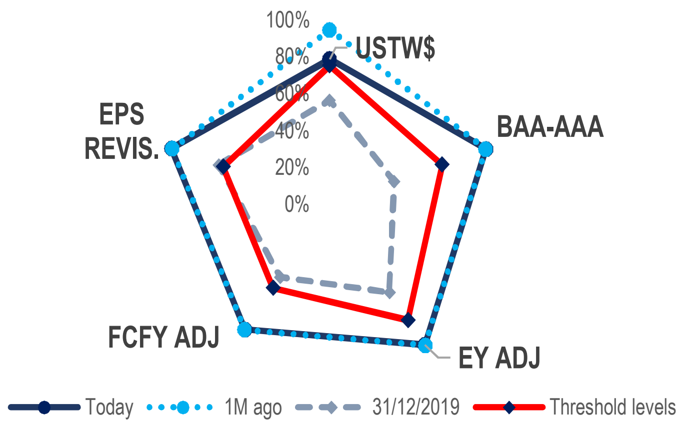
TECHNICALS

— Based on **tactical signals (i.e., technical factors** in addition to pure sentiment indicators) the picture stays mixed. Despite positive signals from technicals (i.e., momentum, with medium term scores this time catching up the positive reading short term score were showing last month), **sentiment indicators still signal a Negative-Risk Environment.**

SENTIMENT

— When looking at financial conditions (which remain tight but eased in response to CB intervention), the banking system's health proxies (Ted, Libor, Comm. Papers) have already retraced close to 10Y min. Banks have, in fact, been provided with huge liquidity. The question is: are they going to circulate it into the system, whatever the risk will be? From flows perspective (State Street data) the mood has been "neutral+" in April/ H1 of May. Deep-diving into Behavioral Risk Scorecard (BRS) indicator in fact, it seems the word on the street stays the same: CBs are difficult to fight, regardless of the visibility on the future.

Cross Asset Sentinels Thresholds (CAST) touching the top



Amundi Research, Data as of 15 May 2020

CAST flags extremely high risk perception.

Sentinels wave above the top on persistent stress in the low-quality credit names as flashed by the Moody's spread (AAA↓↓, Baa↓). EPS revisions continue to run downwards touching all-time lows.

<u>Methodology</u> 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 China-US tensions escalate

China-US tensions escalated on the ramping rhetoric on China's role in handling the pandemic. Tensions involving tariffs and extra tariffs measures (such as against Huawei) will lead to retaliations from China, rendering previous efforts futile. One Chinese reaction could play out in the FX space: we envisaged a risk scenario with the USD/CNY peaking higher at 7.30 from a base case of 7.15. On a broader perspective, Covid-19 might exacerbate current trade tensions into a more structural conflict, leading to a "cold war".

2 Labour market

US: In this first round job losses were concentrated in front-line sectors (i.e., service- and hospitality-related), among small/medium enterprises, lower-pay sectors and employees. There has been a shift in the composition of the pool and computation of average hourly earnings, which have increased significantly. Some unemployed persons were reported as temporary lay-offs. Currently, the 14.7% unemployment rate could be underestimating the full extent of the damage, which will become visible in next few months (second-round effects on deeper economic damages). We estimate that about 30 million jobs are at risk, that unemployment could rise to about 22% and then recede gradually (after peaking in Q2-Q3). Keep an eye on: continuing claims (if and how they decline in states that are opening back up) and labor force participation rate trends (if it remains weak or not – i.e., people coming back to look for a job).

China's economy is recovering (based on macro and micro evidence), showing that the worst is likely behind for the services sector while pressures in manufacturing employment are building up. Balancing these two factors, the unemployment rate is likely to hover at just below 6% in the near term. The worst reading was 6.2% in February.

3 German Constitutional Court ruling

The German Constitutional Court ruling challenges the EU legal architecture. Political ramifications are bigger threats than a short term impact on monetary policy and the economy.
The best strategy is for the ECB not to react, but to acknowledge the ruling and continue business as usual. If not, it would likely pave the way to other national courts to challenge the legal EU framework legitimacy.

4 Increased funding needs

Increased funding needs to create market dislocations and rates pressures. There is limited scope for higher rates, as central banks will monetize additional debt supply and short- and long-dated bonds (Fed to buy unlimited supply of Treasuries and MBS, ECB to increase the size of PEPP). The base case is for the curve to flatten on gloomy economic and inflation expectations.

5 Equity markets

Equity markets are pricing in a reality closer to the upside scenario amid a depressed environment for EPS growth. Valuations had been lifted on central banks' "whatever it takes" and easing of financial conditions. Based on policy responses and lockdowns, we are maintaining our strategic preference for risky assets but the valuation boost does not provide the best upside today. We recommend not chasing equities while preferring the relative safety of IG.

Brexit: The probability of a no-deal is rising

As the third round of negotiation between the UK and the EU has failed to show significant progress, both parties are facing the mounting risk of a no-deal Brexit. Indeed, we are only a few weeks away from the end of June deadline where the UK can still ask for an extension of talks, which it refused to do so far. The **Covid-19 crisis caused some delays** but talks restarted via videoconference. The latest round closed with an exchange of bitter words between the E.U. negotiator Michel Barnier and David Frost representing the UK, highlighting a disagreement on key points including common governance, social and environmental standards, so called **"level playing field"**. Other topics are still unclear such as the solution to avoid a hard border in Ireland or immigration rules.

The roots of misunderstanding are deep. In fact, the EU is still trying to forge a deal, which would allow the UK an extensive access to the Single Market with the obligations that comes with it, while the UK is basically asking for a trade deal-based relationship with light obligations and no oversight from the EU.

The clock is ticking. The European Council scheduled on 18-19th June is supposed to discuss the new treaty with the UK, and seven months look extremely short to finalise a deal and get it approved by 27 member states. Unless both side amend their position and the UK asks for an extension, it becomes more and more likely, the British, which have left the E.U. on 30th January, will not have a trade agreement with its main economic partner on 31st December 2020. Nonetheless, last year after very tense negotiations, both sides finally showed pragmatism and signed the EU-UK Withdrawal agreement.

AMUNDI ASSET CLASS VIEWS

	Asset Class	View	1M change	Rationale
EQUITY PLATFORM	US	-/=		The correlation between economic data (weak) and market performance (positive) has never been so low and markets are pricing in a quick recovery which is too optimistic, in our view. We believe earnings estimates will continue to come down and we stay defensive. However, this cautious view should not be confused with a long term positive stance as US equities are reasonably valued relative to their cost of capital. In addition, the dividend yield of US equities is higher than 10y UST and that is rare.
EQUITY PLATFORM	Europe	-/=		The unprecedented economic 'sudden stop' has already impacted demand and supply in an environment where forward visibility is low and the range of outcomes wide. Therefore, caution is warranted and we recommend investors balance near-term risks with medium-term opportunities by maintaining process discipline, focusing on stock selection and ensuring appropriate liquidity.
EQUITY PLATFORM	Japan	=		Corporate valuations remain below their long-term averages and balance sheets are under-leveraged; but, the current recession and weak global demand will affect earnings. We remain neutral.
EQUITY PLATFORM	Emerging markets	=		We are cautious overall and are exploring names in countries at a later stage of the coronavirus cycle (China, Taiwan, Korea) and in countries with resilient domestic growth and progress in structural reforms (EMEA, India). However, as global uncertainties remain and further trade tensions are looming, there could be headwinds.
FIXED INCOME PLATFORM	US govies	=/+		UST demand remains strong, supported by the QE programme and foreign inflows. While at the latest FOMC the policy rate remained unchanged, the US Congress approved additional fiscal measures leading to a total fiscal stimulus of nearly $3tn. Issuance programme, including long dated bonds, will bring more duration to be absorbed by the market.
FIXED INCOME PLATFORM	US IG Corporate	=/+		IG spreads have tightened and markets have absorbed record issuance of corporate bonds, supported by continued QE. Given this spread-tightening and elevated uncertainty (social, economic and market), selectivity is increasingly important. However, attractive valuations offer compelling return prospects over the next one to two years.
FIXED INCOME PLATFORM	US HY Corporate	-		The Fed's move to unexpectedly expand the scope of its corporate security purchase programmes in early April to include crisis-related 'fallen angels' as well as HY ETFs supported activity and spread tightening. Despite all that, we remain very cautious and focus on quality, as any economic recovery is likely to be slow.
FIXED INCOME PLATFORM	European govies	-/=		We stay cautious and wait to see how the recent agreement between France and Germany to push for a recovery fund is received by other EU member states. We are still mildly constructive on peripheral bonds.
FIXED INCOME PLATFORM	Euro IG Corporate	++		EUR IG should benefit from the current normalisation environment and the ECB's large liquidity backstop. We remain positive on EUR IG, particularly on the subordinated debt financial sector,
FIXED INCOME PLATFORM	Euro HY Corporate	-/=		We remain selective on industrials sectors such as auto, as well as on pharmaceuticals and media. Overall, we think, liquidity is stabilising, but is still tight in the current market environment.
FIXED INCOME PLATFORM	EM Bonds HC	=/+		Covid-19 and oil dynamics are shaping the economic environment for EM and in general we have been cautious. We remain positive on HC debt, where we have a constructive stance on selective HY names, and also believe that some IG primary market offerings are attractive.
FIXED INCOME PLATFORM	EM Bonds LC	=		We like local rates and believe selectivity is important in countries such as Mexico and South Africa. Russia continues to offer attractive value. Note that we remain cautious on FX.
OTHER	Commodities			Cyclical commodities are not supported by the economic backdrop, due to the global lockdown, and oil is suffering the same fate. While oil prices will benefit from a restoration of economic activities, markets are still discounting a huge structural oversupply and a no-recovery scenario. Gold remains the great winner in this framework, as it benefits simultaneously from economic uncertainty, increasing government deficits and central bank QE purchase programmes.
OTHER	Currencies			While CB and government interventions have helped contain credit risk and ease financial conditions, the USD stayed resilient, with depreciation visible against only a few currencies. In addition, when we look at fundamentals, the US Dollar Index (DXY) trades at a premium to its fair value. However, valuations don't work properly in uncertain times and during capitulating growth expectations. The EUR has been an underperformer as EZ growth is collapsing (more than US) and the outcome of the German court ruling had an impact. But Franco-German agreement on a recovery fund could be positive. Our 12M target for the EUR/USD is 1.14.

LEGEND

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	Negative		Neutral		Positive		Downgrade vs previous month	Upgraded vs previous month

Source: Amundi, as of 25 May 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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