CENTRAL & ALTERNATIVE SCENARIOS

Monthly update

We marginally amend the narrative of our central and alternative scenario on the back of recent development. Recent data confirm a slower recovery path in line with our central scenario. We therefore increase the probability of our central scenario from 60% to 70% while reducing the likelihood of the upside alternative scenario from 20% to 10%.

DOWNSIDE SCENARIO 20%

Secular stagnation

Analysis

- Economic relapse (Q4 2020/Q1 2021).
- Policy accelerators in place but with diminishing impact: liquidity does not feed through to the real economy and the labour market suffers fading employment benefits.
- Economic crisis evolves into a financial crisis.
- Protectionism and deglobalisation accelerate, negatively affecting trade and global value chains.
- Vaccine efficacy is limited and/ or people's compliance is poor

Market implications

- Favour cash and US Treasuries.
- Favour gold, CHF, Yen, NZD.
- Use minimum volatility strategies.

CENTRAL SCENARIO 70%

Slow U-shaped recovery

Analysis

- Short-term rebound (Q3), flatter and gradual convergence to pre-crisis levels, with significant divergences on timing. Economic backdrop still in the grip of the pandemic as a vaccine won't be available before H2 2021.
- Credit fragmentation and rising default rates.
- Debt monetisation and ballooning CB balance sheets.
- Global trade recovers on economies re-opening, driving the global cycle as well as domestic engines.
- Widening social gaps and inequalities

Market implications

- Sideways dynamics prevent directional positioning.
- In fixed income, be active in duration management (favour US, EU peripherals), prefer carry to beta.
- Long BBB/BB, very selective on low high yield rated issuers, cautious on EM FX. USD to be monitored.
- In equities, for the rally to continue a widening of the market's breadth beyond the FAANGs is required. Prefer long-term winners, maintain the tilt to cyclicals.
- Favour gold on pervasive uncertainty.

UPSIDE SCENARIO 10%

V-shaped recovery

Analysis

- Economic activity recovers to pre-crisis levels by mid-2021 (US, Eurozone), with above-potential growth in H2 2020 and H1 2021.
- Pandemic almost eradicated with medical treatments for cure and prevention. A vaccine is available H1 2021.
- Monetary and fiscal stimuli feed through to the real economy and financial markets.

Market implications

- Favour risky assets with a rotation from credit to equity and commodities (oil).
- Favour linkers.
- Negative USD driven by negative interest rates and widening interest rate differential with the RoW.

Covid-19 update: managing summer tourists' way back

Over the recent weeks, the number of cases in Europe has continued to rise, in particular in those countries that have registered an increase of visitors during the summer break. It is also true, though, that there has been a ramp-up in testing, and we will need to wait mid-September to draw conclusions that are more indicative of the potential for a second wave. In the worst case, we do believe that lockdowns, if any, will be selective, as economies are too fragile to afford extensive shutdowns. In contrast, in the US the number of cases has fallen almost 40% since peaking in July, providing a boost to its equity markets.

On a more long-term perspective: medical treatment is improving, including the use of blood plasma from survivors. Despite the lack of trial data, markets welcomed the US regulators' approval of plasma transfusion. A much bigger focus is scaling up production of specific antibodies (more than 70 are now under deployment by different companies) that will likely have the potential for both therapy and prevention. These treatments (in the end more expensive than vaccines) will likely be ready for the next summer, while companies are working together to boost production that will have to be massive.

TOP RISKS

Monthly update

Risks are clustered to ease the detection of hedging strategies, but they are obviously linked. We maintain the overall narrative and probabilities on the risk outlook with the pandemic exacerbating existing fragilities and vulnerabilities.

ECONOMIC RISK 10%

Depression

- **No V-shaped recovery but a dismal labour market**
  - After a fast recovery the economy might slow down or even decelerate
  - While all policy efforts and social benefits have been activated to preserve personal income, the deterioration of the labour market might still derail the recovery
- **Inflation surprises**
  - QE programs may become problematic during a recovery when inflation enters the equation.
  - We have seen the Fed reducing its balance sheet expansion over the summer on the back of higher inflation prints
  - Inflation dynamics and the CB reaction function could be sources of uncertainty. In particular, EM inflation is at an inflection point but the trend ahead remains comfortable due to depressed demand (watch Turkey, India and Mexico)
- **A second Covid-19 wave**
  - The fast-growing number of cases in Europe raises the risk of a second wave during the back-to-school period
  - Although our ability to deal with the virus has improved significantly (e.g., treatment, health infrastructure, and social distancing), the fallout in sentiment, consumer spending and the economic recovery could be negative, and trigger a W-shaped recovery.

+ 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 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 spillover into the credit market and stress on banks' balance sheets
- **Sovereign debt crisis**
  - Public debt will rise as a share of GDP across most countries in the coming years, starting from already high levels in Europe, Japan and the United States. This could lead to rating downgrades and rising interest rates over the long term
  - Emerging market fragilities (single commodity exporters, tourism), could also face a balance of payment crisis and increase default risks
  - Risks incurred in implementing the European Recovery Fund should not be underestimated. Dissensions among EU members could bring back EZ periphery bond risk

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

- Oil, risky assets, frontier markets and EM

(GEO)POLITICAL RISK 15%

Covid-19 exacerbates political tensions

- **US elections and China tensions**
  - The US elections campaign and tough rhetoric from President Trump could exacerbate tensions with China.
  - The equally hawkish tone from Democratic Party brings new policy uncertainties to the bilateral relationship in a Biden-win scenario.
  - On top of the tech war & Huawei, the capital war on foreign holdings and reshoring out of the global supply chain, the situation in HK introduces risks of possible US sanctions on Chinese banks and exclusion from the USD system.
  - Possible accidental confrontations in the South China Sea or the Taiwan Strait
- **Instability within and among EM countries**
  - The health and economic crisis, combined with the US moving away from multilateralism and with incoming elections, are potentially conducive to geopolitical stress and national instability within EM.
  - At this point, there is no identified 'systemic' crisis with market impact, but a number of events are worth monitoring, including Libya, Greece/Turkey, Lebanon, Belarus, protests in Eastern Russia, and the India & China border dispute
  - For Turkey, which is already on very thin ice with domestic imbalances flashing warning lights, economic headwinds carry additional risks

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

- Oil, risky assets, EMBI

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

- Operating conditions continue to improve with firms reporting strengthening business activity across an increasing number of major sectors.
- Service providers highlighted the weak global demand and the restrictive measures still in place across the globe as the key drags, disrupting in particular tourism and leisure related activities. Accordingly, divergences across sectors intensified recently.
- The recovery rate is moderating within the main Eurozone economies.

FUNDAMENTALS & VALUATION

- **Risky assets look expensive from almost all traditional metrics.**
- For equities absolute PEs look very high even considering high EPS expectations. Low Equity Risk Premium is still a valid argument thanks to extremely low interest rates and Central Banks balance sheet expansion.
- So far, CBs have prevented any negative spillovers of the recession on corporate default rates protecting credit investors and banks.

DEFENSIVE ASSET ALLOCATION

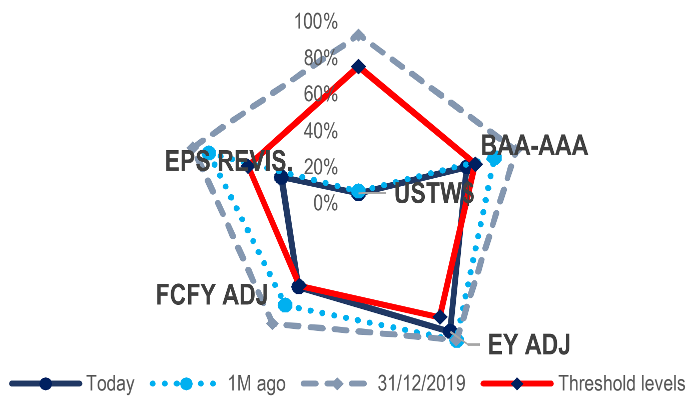
TECHNICALS

- Tactical signals (technical factors in addition to pure sentiment indicators) are **showing an improvement recently and momentum is still in favour of markets.**
- From a contrarian point of view, markets seem a bit stretched though.

SENTIMENT

- Financial conditions eased over the summer on the back of Central Banks' intervention i) banking system's health proxies (TED, Libor/OIS, Comm. Papers) are back to normal levels and, ii) corporate spreads have tightened further.
- **CAST component remains the main contributor in sentiment with almost all components in "ON" territory.**
- From a flow perspective (State Street data), the mood still in RISK ON territory with renewed appetite for high yielders (both corporate and sovereign) and equities lately.

Cross Asset Sentinels Thresholds (CAST) still supportive



Amundi Research, Data as of 25 August 2020

CAST flags extremely low risk perception.

Sentinels remain in pro risk territory due to a general improvement in all the components (except ERP adjusted for credit risk).

<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 visualizes 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 V shape recovery

We don't buy the V-shaped view markets are pricing in

- The fastest part of the recovery is over. A flatter, more gradual track will follow. The economic backdrop remains fragile and is still in the grip of the pandemic.
- Preliminary Q2 data were broadly in line with our expectations, with no major revisions on the growth front except negative surprises in Spain and Germany. Q3 GDP tracking seems to confirm our expectations of slowing momentum in late July, in line with a gradual recovery. The resurgence of cases is an emerging risk after a post-lockdown rebound in activity.
- After the Q1 and Q2 declines, the Q3 recovery does not seem enough to bring most economies back to normal. Economic performance will progress along a slow upward sloping catching-up process. A vaccine would avoid temporary damage morphing into long-lasting loss and reinforce the recovery.
- Policy measures in developed markets have primarily targeted households' income preservation with the prospect of a V-shaped recovery via different forms of employment benefit. We therefore see a risk in the transition towards 2021, when these benefits will progressively expire. Consumption remained resilient but will be likely be challenged in the event that labour market conditions deteriorate.
- In our central scenario, this implies GDP pre-Covid levels not being reached before several quarters from now on average, with China being the exception. This translates in our cautious projections on EPS growth that we expect to rebound in 2021 albeit to lower levels than expected by the consensus.

2 Eurozone debt market

Eurozone funding needs are almost covered for the year, lightening the pressure on ECB and allowing some relapse on asset purchase programs

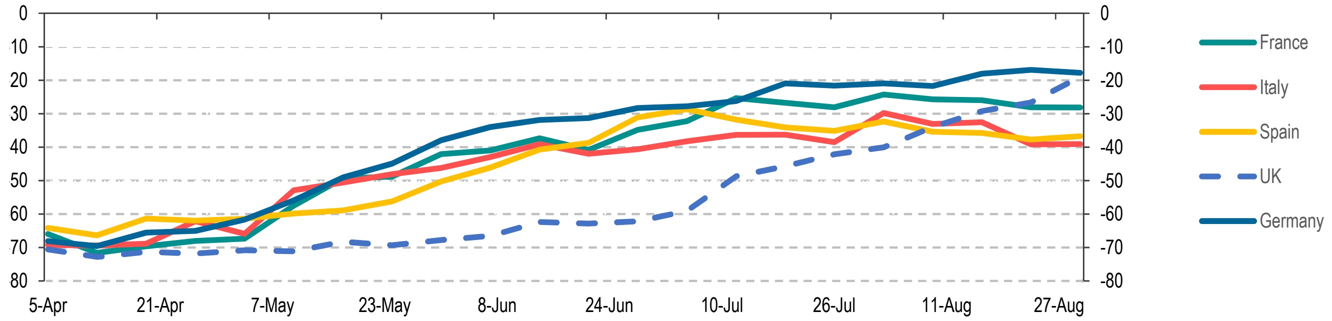
- The technical picture for Eurozone (EZ) government bond looks friendly to the current environment of low core yields and subsequent search for carry.
- According to our estimates, the ECB has so far covered for most of YTD net supply, for many countries reaching a proportion of 90% of bonds net issuance. Assuming that most of QE overall potential will be allocated to public debt (80%) through capital key rules, with a proportion of two thirds this year and one third left in H1 next year, the ECB purchases should more than cover for remaining fiscal needs until year end.
- EZ yields are at lows and spreads tightened not far from pre-Covid levels. As a result, the ECB is gaining flexibility to be potentially used to support private programs and keep sovereign bond purchase capacity for next year as a backstop in case of need or banks' year-end holding rebalancing.
- However, EZ banks are incentives to keep govies holdings in the current environment of very attractive ECB funding facilities and negative rates charged on excess reserves, which therefore limit an eventual reduction in exposure.
- This demand/supply backdrop is likely to support the present environment of low and negative yields in core countries, while, at the same time, supporting carry search through periphery debt.

3 Fragile momentum

Markets dynamic should be more sideways going forward

- We don't expect the global economy to get into pre-Covid levels soon, in the labour market (unemployment) in particular, and believe the market is pricing in an unrealistic V-shaped recovery.
- Valuations are highly distorted by central banks activities, and we consider current stock market levels are pricing in our base scenario fully. Slicing and dicing broad equity indices, we notice a highly polarized market that definitely offers opportunities for stock pickers but constitute a risk where extreme, too.
- We are therefore avoiding directional exposure to equities since the dispersion of returns and valuation between regions (mainly US) and sectors (Tech) makes the momentum fragile. We see rising political risk and macro imbalances in EMs.

Recovery Tracker



Source: Blavatnik School of Government, University of Oxford, ENTSO-E, OpenTable, ShopperTrack, Moovit App, Amundi Research - Data as of 30/08/2020

AMUNDI ASSET CLASS VIEWS

	Asset Class	View	1M change	Rationale
EQUITY PLATFORM	US	-/=		US equities continue to offer better value than bonds; however, the momentum and valuation divergence between mega caps and large caps vs. the rest of the market is extreme. This is despite the uncertainty around US elections and a resurgence of virus cases in some states. In this environment, it is important to remain balanced. We believe a leadership rotation is likely, and investors should look to high quality value names.
EQUITY PLATFORM	Europe	=		The economic environment is improving but the risks of a second wave of the virus have emerged that could affect a staggered recovery. The Q2 earnings season surpassed expectations which were already depressed, with very low forward visibility. As a result, valuation dispersions remain high. Looking ahead, investors should stay very selective and aim to identify resilient business models.
EQUITY PLATFORM	Japan	=		Improving prospects for global growth and a favourable environment for cyclical stocks should benefit Japanese equities, given the country's dependence on exports.
EQUITY PLATFORM	Emerging markets	=		Geopolitical issues such as US-China relations and the Covid-19 pandemic are the key factors affecting emerging markets at the moment and we favour countries in the Asian region (South Korea, China) in light of our first-in, first-out approach. Some countries in the EMEA region have attractive valuations and we also like those with good dividend yield prospects such as Russia and Poland.
FIXED INCOME PLATFORM	US govies	=/+		From a global fixed income standpoint, we prefer USTs for their safe-haven status but we don't make any strong call on duration overall. From a US portfolio perspective, we are cautious in light of certain factors such as pick-up in economic activity and deficit spending which could weigh on the market.
FIXED INCOME PLATFORM	US IG Corporate	=/+		Stimulus measures continue to support demand for IG, but markets are now already discounting the impact of additional stimulus and vaccine effects. We recommend investors to maintain appropriate liquidity buffers and take profits in bonds and loans where appropriate. Overall, name and sector selectivity is essential to avoid permanent impairment.
FIXED INCOME PLATFORM	US HY Corporate	-/=		While the Fed's actions should support this asset class, in order to avoid defaults and safeguard portfolios investors should focus on high quality and liquid names that can withstand a slow-paced recovery.
FIXED INCOME PLATFORM	European govies	-/=		We maintain our cautious stance on core Euro and remain positive on peripherals, although investors should lock in some gains. Core Euro yield-curve steepening seems unlikely for the time being, as the ECB should limit rate hikes amid subdued inflation.
FIXED INCOME PLATFORM	Euro IG Corporate	++		We are constructive on EUR IG, and believe overall defaults in European credit have been stable. The leverage of IG companies in the Eurozone remains lower than that of their US counterparts and overall cost of funding is also lower thanks to ECB support. While we maintain our positive view on financial and subordinated debt in IG, overall, we are keeping an eye on heavy issuance in September. All in all, selection remains paramount.
FIXED INCOME PLATFORM	Euro HY Corporate	=		The high-rated BB segment BB in HY still presents opportunities on a selective basis. We are cautious here and look for extra yield in names that can successfully emerge out of the crisis. As always, focus on liquidity is important.
FIXED INCOME PLATFORM	EM Bonds HC	=/+		We continue to favour Hard Currency (Euro over USD) EM debt. We see room for further spread compression in HY and are turning cautious on IG. Overall IG sovereign spreads are only 30 bps off their pre-Covid tights whilst HY spreads remain 300 bps above their pre-Covid tights. However, risks of sovereign defaults should be monitored.
FIXED INCOME PLATFORM	EM Bonds LC	=		We are neutral/cautious on EM rates and continue to believe that selectivity is essential. On EM forex, we are constructive on commodity currencies amid a staggered reopening of economies and an oil price rebound.
OTHER	Commodities			Economic recovery favours commodities, although uncertainties prevail over the evolution of the pandemic and possible lockdowns. However, recent macro numbers in China and the US remain supportive. In general, commodities are still the cheapest risky asset class, and may well benefit more than others from an economic recovery. Oil demand is expected to recover after collapsing by 11 million b/d in H1, and we project an oil price of $/b 35-45 for the WTI. In metals, the recent sell-off in gold (and silver) is related to the concerns of higher real rates, "normal" risk-on and the Fed pausing its assets purchases. However, CBs will remain extra dovish, preventing any painful sell-off going forward.
OTHER	Currencies			Central bank interventions, initiatives at national level and the EU recovery fund have stabilized sentiment towards EUR/USD, but, the path for USD correction as we move toward 2021 will not be linear and we could see a stabilization of the USD against the EUR. As far as GBP is concerned, the environment is more favourable for the EUR when we consider regional growth, financial conditions and political risk premium (Brexit).

LEGEND

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	Negative		Neutral		Positive		Downgrade vs previous month	Upgraded vs previous month

Source: Amundi, as of 31 August 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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