THIS MONTH'S TOPIC

DEFEND Monica
Global Head of Research

With the contribution of:

BERARDI Alessia,
Head of Emerging Markets Macro and Strategy Research

PORTELLI Lorenzo
Head of Cross Asset Research

USARDI Annalisa,
Senior Economist, CFA

2021 global outlook reassessed

As the Q420 is now closed, we confirm the "financial recovery regime" as our central scenario for 2021 with a higher conviction than in Q320. We expect better corporate fundamentals at a global level going forward. The rebound of EPS growth will eventually validate current asset price levels in the context of low interest rates. This explains our cautious optimism for the coming quarters. We have also analysed the sustainability of the ongoing risk rotation from Credit HY to value/cyclical equities. We confirm our constructive medium-term view with a continuation and maturing of the financial recovery regime.

I - Updating our 2021 economic outlook

Growth outlook reloaded

▶ Implications of 4Q20

Compared to our previous quarter assessment**, the outlook for economic growth in 2021 has seen a mild shift in favour of Emerging Economies.**

Growth has become firmer in the US and has slightly improved in Japan driven by more substantial fiscal support plans in the US, and by a stronger base effect than in 2020 in Japan. In Europe, 2021 growth expectations are curtailed due to the current developments in the pandemic and weaker base effects than in 2020 (better-than-expected growth in Q3).

Growth in the Emerging Markets increased mildly in 2020 versus expectations on stronger-than-anticipated Q3, while expectations have remained stable in 2021 with the exception of Brazil and South Africa. In both of these countries, we expect a weaker base effect in 2021 than in 2020. Moreover, a slower resolution of the fiscal situation in Brazil and a less buoyant global economy at the turn of the year should weigh on growth, on top of the new lockdown measures enforced in South Africa.

The ongoing supportive policy mix is the main driver behind our constructive growth outlook in both the DM and EM. The effectiveness of the vaccine and herd immunisation through its mass distribution in 2021 are pivotal assumptions on which this outlook hinges.

Inflation in advanced economies is set to remain broadly in check or subdued, with of some temporary jumps linked to reversing base effects. While we see progress made toward the targets of DM central banks, we do not expect to see uncontrolled inflation in the foreseeable future. **Inflationary trends in the EM look more mixed.** In most cases, recent dynamics, particularly in China, have been dictated by specific and seasonal factors, and therefore temporary. Still, there are idiosyncratic stories, such as Turkey, where inflation should remain very high due to strong currency depreciation, a rise in electricity prices and the progressive phase-out of various VAT cuts introduced in 2020. **Overall, inflation in emerging economies is already at or closer to the CBs targets than in advanced economies.**

▶ Reiterate our 2021 global growth forecast

From a growth perspective, **our global outlook for 2021 remains broadly stable**; while still dominated by base effects, it also factors in moderately stronger quarterly growth patterns. As of December 31st, our 2021 global growth assumption ranges from **4.9% to 5.7%.** The **fiscal lever will be a key driver** in supporting the recovery, especially in AEs. In the US, while the vaccination campaign remains in progress but virus containment measures could still dampen activity. A new fiscal package will support the economy in the first half of the year (worth almost 1% of 2021 GDP growth, according to our calculations). There is some upside to our expectations as we conservatively embedded a skinnier package in our original projections than the USD900b signed by the US President on December 27th. Moreover with the majority in Congress post the senate runoffs in Georgia, Joe Biden should be able to add further fiscal stimulus. In the Eurozone, the *Next Generation EU (NGEU)* plan is a key factor that is expected to drive growth above potential from the second part of the year, particularly in key vulnerable countries. We expect EZ growth to be steady and range from 4.3 to 5.1% in 2021 and from 3.6 % 4.2% in 2022 outperforming the US (see table following page). The combination of the vaccination campaign reaching "herd immunity" level and the release of pent-up-demand reinforcing the plan's impact, creating a sort of virtuous cycle, is a key feature of this scenario. We should therefore be vigilant on the implementation risks.

With growth recovering somewhat faster, the inflation outlook has been broadly muted, in particular in the DMs due to a broad deceleration in the second half of 2020. The new wave of the virus in Q4 introduced an additional source of volatility to the macro data, with the new restrictions impacting activity, particularly in the services sector. While representing only a proxy, a broad set of high-frequency indicators such as mobility

THIS MONTH'S TOPIC

data and electricity consumption tend to show a new decline in Q4 in areas where more severe lockdowns were implemented (e.g. the Eurozone), in line with the scenario of a gradual but uneven recovery.

Relapses in the real economy will occur due to virus outbreaks, while policy intervention will hopefully be an option to help speed things along. Moreover, the world's central banks are committed to maintaining unconventional monetary policies and easing financial conditions for a long period of time. **This will support the financial markets when corporate fundamentals rebound**[1].

As a conclusion, the new wave of infections and the selective lockdowns implemented in several countries across the different regions makes the global economic recovery increasingly uneven and heterogeneous. The speed and effectiveness of the vaccination campaign will be key drivers in releasing pent-up demand, and shaping the recovery growth trajectories, together with the fiscal and monetary policy mixes.

[1] *In our central scenario, this translates into pre-Covid 19 economic levels not being reached for several more quarters on average (with the exception of China, the only economy showing a proper V shaped recovery).*

What surprised in the Q4 2020

While uncertainty remains pervasive, our short-term cautious optimism takes the following into account.

- **While progress on vaccine availability increased somewhat faster than we had anticipated, the new wave of infections across regions and particularly in the US and Europe may offset the confidence from the early start of the vaccination campaign**. The health measures to tackle the new wave, implemented with different degrees of severity and implications for mobility, are generating a remarkable deceleration in high frequency data, and in some regions causing an economic contraction. While in the US these developments do not seem to have compromised Q4 growth, even if it is has slowed significantly, in Europe there are signs of an outright contraction, albeit at a fraction of that seen in Q2. The recovery should resume gradually and unevenly from Q1 2021. Growth over the year should be driven by extraordinary base effects which should offset the unprecedented losses in Q2 2020.
- In the US, the odds of a **bi-partisan fiscal package** being delivered during the lame duck period seemed low a few months ago, yet before the year-end Congress approved a USD900+ billion fiscal package that should offset the weak momentum seen in Q4, lift households' disposable income in the first half of the year, and revive growth momentum.
- In the EU, the **recent agreement on the NGEU multi-annual budget** gives the green light for its implementation, overcoming the opposition previously expressed by Poland and Hungary, which made the negotiations tougher and increased uncertainty around its delivery and the timing of its implementation.
- The **financial markets kept a close eye on the pandemic logistics** and moved on the positive vaccine-related news flows, the fiscal plans and the reduction in political risk, surprising us on the upside more than any rosy expectations, and implying a tactical repositioning.

Macroeconomic forecasts (with information available as of December 31, 2020)

Annual averages (%)	Real GDP growth (%)			Inflation (CPI, yoy, %)		
	2020	2021	2022	2020	2021	2022
		range				
Developed countries	**-5.7/-5.3**	**3.7/4.5**	**2.8/3.4**	**0.7**	**1.3**	**1.6**
US	-3.7/-3.3	3.7/4.7	2.4/3.0	1.3	1.9	2.0
Japan	-5.6/-5.0	2.3/2.9	1.3/1.9	0.0	0.1	0.2
Eurozone	-7.6/-7.0	4.3/5.1	3.6/4.2	0.2	0.9	1.4
UK	-11.5/-11.1	3.5/4.1	4.4/5.0	0.9	1.7	1.9
Emerging countries	**-2.9/-2.2**	**5.7/6.5**	**3.9/4.9**	**3.9**	**3.6**	**3.7**
China	1.4/2.0	7.9/8.5	4.9/5.5	2.5	1.4	2.2
World	**-4.1/-3.5**	**4.9/5.7**	**3.5/4.3**	**2.6**	**2.7**	**2.8**

Source: Amundi Research

THIS MONTH'S TOPIC

We are convinced that inflation next year will trend higher and episodically spike mainly on base effects

Inflation: the elephant in the room

In 2021, inflation and inflationary expectations are likely to be in the spotlight.

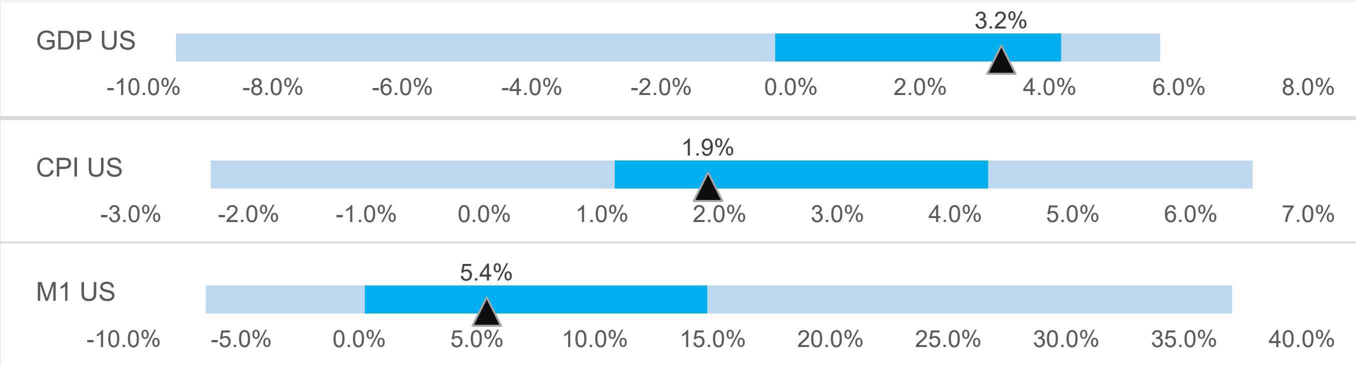
During the 4th quarter, **inflation was a relevant factor but not a market mover.** US inflation was weak on key drivers such as shelter and medical services decelerating considerably, while EU inflation remained in negative territory. We therefore feel it would be premature to assume that inflation expectations are anchored at higher levels.

In general, we expect **fiscal and monetary policy coordination to continue, with monetary policy facilitating fiscal expansion regardless of short-term inflation pressures**. In fact, the major DM central banks are revisiting as expected their longer-term policy guidelines after constantly missing their inflation targets and thus allowing for extended periods of policy easing even in the case of modest increase of inflation. In EM, by contrast, the monetary authorities must balance their policies more carefully in light of very different inflation dynamics, and we expect a stable monetary policy stance (a marginal tightening in some cases only) on the back of a gradual recovery later on.

As a conclusion, we believe **inflation in DM** may experience **unusual volatility** in the months to come, due to lockdown-induced distortions and base effects, which should reverse in 2021. As long as the output gap remains open, global and local deflationary forces may put a lid on inflation, whilst the fading negative drag from the oil base effect should help inflation grind higher over next 12 months together with vanishing base effects from VAT cuts, where implemented (e.g. Germany). **In EM**, **the overall picture is expected to remain benign, with headline inflation remaining within or close to the CBs' targets;** however, price dynamics and expectations are worth monitoring, given the huge dovish efforts made by most CBs.

Mapping US economic expectations.

Looking at Q4 2021, strong and above median growth does not lead to persistent inflation overheating, notwithstanding the monetary policy support delivered so far. Quite the opposite, inflation moves towards the target but remains subdued.



Source: Amundi Global Research, Bloomberg, Eikon – Datastream, January 2020.

Methodology: The table represents each variable (e.g. GDP US YoY, CPI US YoY, US M1 acceleration) expected value in Q4 2021 (black triangle) compared to two ranges:

- light blue: the historical min and max values reached by the series over the sample period (starting 1988)
- dark blue: the min and max values of the variable distribution conditioned to the estimated probability of each macro-financial phase as computed in the AIP framework.

This enables to evaluate how the forecasts position compared to the typical distribution of the expected financial regime as per the Advanced Investment Phazer 12 months ahead.

II - Rebalancing the probabilities of our scenario

As 2021 gets underway**, we expect the road to recovery to remain bumpy**, shaped on the one hand by waves of optimism linked to **progress in the mass vaccination** campaign and on the other hand by **virus containment measures**, which we do not expect to be lifted fully before Q3.

We reviewed the probability assigned to our central and alternative scenarios in terms of expected financial regimes compared to the previous quarter. **Our scenarios are contingent on the pace of the massive vaccine rollouts**, which we expect to be non-linear and uneven

Increasing the probability of our central scenario to 75%

We have a higher conviction on our **central scenario** and we raise its probability from 65% to 75%. This scenario assumes that getting the world back in order will be a multi-year process, with relapses in the real economy due to virus outbreaks, while policy intervention will be an option to help speed things along.

THIS MONTH'S TOPIC

Q4 recovery path diverges across regions as a new wave of infections prompts lockdowns, partially offsetting the sentiment boost provided by the earlier-than-expected start of the vaccination campaign

The risk rotation that began in Q4 20 should continue over the coming quarters

According to our estimates, corporate earnings will prove resilient and rebound from their 2020 lows as economic activity resumes. Managed low interest rates should further lift the equity markets, helping to maintain the remarkable gap that emerged between the financial markets and the economy during 2020, sustained by resolute policies.

We confirm our constructive medium-term view of a continued and maturing recovery, with more cautious optimism in the short term as far as financial markets are concerned.

Our optimism hinges on three key achievements of the 4th quarter:

1) **tangible progress in the Covid-19 vaccine** front since November, leading us to be more confident of a "vaccine-enabled" recovery, supported by
2) gradual **progress on fiscal support** allowing us to improve our economic projections[2]. We believe that fiscal expenditure will have the highest impact by selectively addressing (welfare) support in those sectors that have been hardly hit by the health restrictions. All G4 central banks have further committed to maintaining accommodative financing conditions to stabilise the financial markets and monetise sovereign debt issuances to boost economic growth.
3) major **political risks** (including US elections, hard Brexit) have disappeared and therefore reduced financial markets volatility.

▶ The probability of the downside scenario remains high at 15%

Markets participants were a bit early in pricing in a "vaccine enabled" economic recovery. Our downside risks, priced with a probability rate of 15% (down from 25%), remain high and above the historical trend, Hence our cautiousness on the short-term market moves.

We see three main catalysts, which could trigger our downside scenario:

1) **a genetic evolution of the virus** which could drive the pandemic out of control again and lead to negative growth shocks.
2) **policy mistakes,** such as execution risk of fiscal plans, or monetary policies being paused or seeing a correction in part of their accommodative stance. The Federal Reserve for instance could be under pressure because of a free fall in the USD, de-anchoring rates or inflation expectations. The latter being consensus trade, it represents a risk per se and might play out as game changers in the scenarios.
3) **a prolonged economic downturn** affecting business and consumer confidence and looping into sectors that have not yet been infiltrated by the crisis (i.e. the financial sector) and causing the exceptional economic crisis to evolve into a financial crisis.

▶ The upside risks with 10% probability

Our upside scenario entails the health crisis being solved in H1 2021, confirming a sustained **"vaccine- enabled" recovery.** An orderly rebalancing of policy mixes with a boost in economic activity would intiate a virtuous path of economic recovery, prompting productivity gains on new digital/green developments, and a faster normalisation. Private demand would resurge, leading to a demand-led increase of inflation albeit benign.

Investment implications

Given the new probabilities of our central and alternative scenario, we recommend well diversified portfolios, with balanced risk exposures, which are resilient to rising volatility in the case of negative shocks pertaining to growth or institutional policies. We expect corporate earnings to rebound, underpinning even higher risky asset price levels in the context of interest rates controlled by central banks. This should sustain the ongoing risk rotation from Credit HY to value/cyclical equities and into EM assets.

III - Medium-term Investment outlook

Conveying our top-down assessment into the Advanced Investment Phazer framework

We have described all the ingredients of our cycle indicator, the Advanced Investment Phazer, which underpins our medium-term investment views. Within this framework, we bridge our views and expectations on the macro outlook to our convictions and investment strategy.

We confirm the financial "recovery regime" as a central scenario (with 75% prob.), with growth and macro determinants remaining paramount. On our economic radar, the softening seen in Q4 2020 should not derail the 2021 rebound. Nevertheless, the convergence of economic growth to pre-crisis levels will be a slow and bumpy path due to the serious structural damage caused by the pandemic to labour intensive sectors.

Our analysis based on **long-term growth determinants shows that potential growth has been severely hit by the**

[2] ***This time, we explicitly added fiscal expenditure support*** *(i.e. approx. USD500bn for the US with effects in Q1 and Q2 mainly, computed in line with CBO fiscal multiplier estimates; for the Eurozone, between 15% and 20% of the allocated RRF grants for each beneficiary country, with effects from Q3 mainly, estimated with multipliers in line with each DBP presented to the EU Commission).*

THIS MONTH'S TOPIC

pandemic via all three growth channels (loss of productivity, lower capital investment and diminished labour force participation), effects that will be reversed only gradually over the medium term. However, **corporate earnings should be more resilient and faster in recovering to pre-crisis levels** (in the US, we expect 2021 EPS to drift even higher than December 2019 levels). More importantly, **asset price dynamics should not be a game changer for CBs' monetary policies**, and liquidity injections should remain solid, underpinning asset reflation and preserving positive financing and financial conditions.

Policy accelerators support risk assets, but the decoupling from their fundamentals increases downside risks. This is reflected in the probability we assign to the downside scenario (15%), which includes a potential market correction above 10% i.e. in line with historical average.

Search for yield and diversification

Within this environment, **the search for yield is still the dominant theme** along the fixed-income spectrum: the focus switches however to **emerging market bonds, for diversification purposes and expected returns perspectives.** In fact, the mix of a weak US dollar, the time premium adjusted income and the improving economic conditions in the EM regions are tailwinds to global emerging market bonds. Moreover, easing financial conditions pioneered by central banks are preventing volatility spikes in GEM yield curves too**.** We reiterate our preference for **inflation linkers** over government bonds. Inflation expectations are anchored at low levels, and this is therefore a cheap hedge to have in case they move higher going forward.

Equities are the favourite pick within risky assets

The **resilience of corporate earnings** in the context of managed interest rates should help equities to hit new highs in 2021-22 without assuming skyrocketing multiple levels. We expect price-to-earnings ratios to revert gradually to the historical median. Therefore, **from a risk return profile, the equity market remains the favourite pick within risky asset classes.**

Moreover, we expect the ongoing rotation from Credit HY to equities, at least in developed markets, to continue. Although the volatility of HY decreased significantly in 2020, the potential upside from extremely and artificially tight spread levels is more limited than in past recoveries.

Q4 asset class rotation and the performance of risky assets significantly reduced the market dislocation and the undervaluation in the laggards (global equities risk premium vs. yield, cyclical assets, commodities and in general all reflation trades).

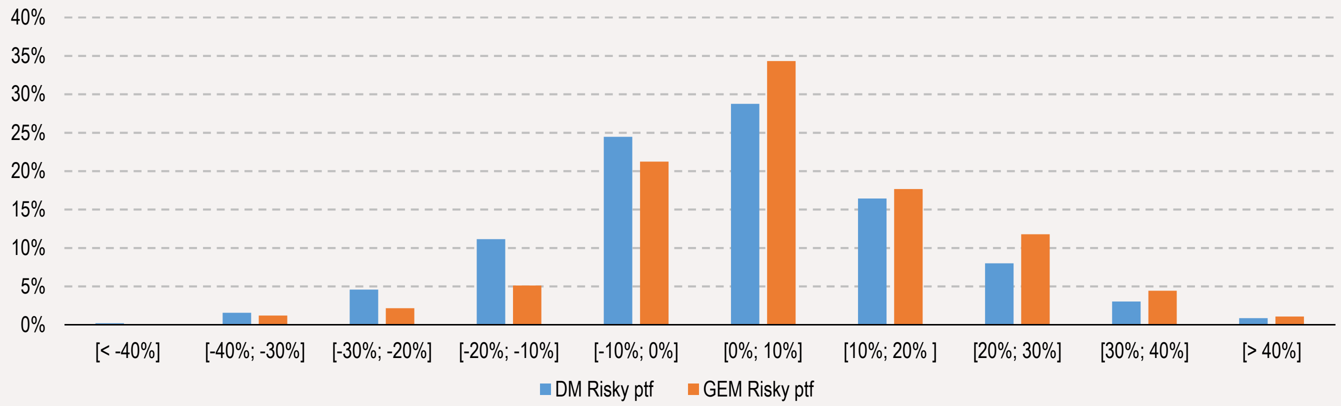
Reality check on the continuation and sustainability of the rotation

According to our analysis, **the rotation is sustainable over time.** We recognise **higher potential in the Eurozone when switching from HY to equities**; the recent catch-up of this trade in the US has almost exhausted the relative appeal in the region. **Investment opportunities in the GEM risky assets spectrum will continue to be available in 1H21.**

In light of these considerations, we feel it is appropriate to **maintain the rotation trade, focusing even more on lagging asset classes and playing this theme at cross-asset level in order to guarantee the right risk diversification**.

In the recovery financial regime, our central case, Global Emerging risky assets (HY+Equities) outperform on average Developed Markets risk assets mainly thanks to cheaper top down valuations.

1/ **Expected returns - DM Risky portfolio vs GEM Risky portfolio**

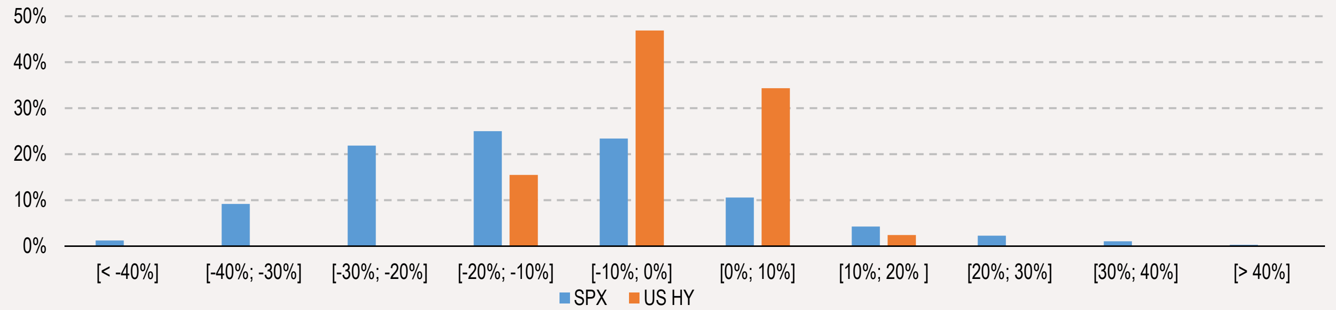


Source: Amundi Research, Bloomberg, Standard & Poor Website, January 2021, X axis reports portfolios expected return range, y axis reports the frequency of the probability distribution.

THIS MONTH'S TOPIC

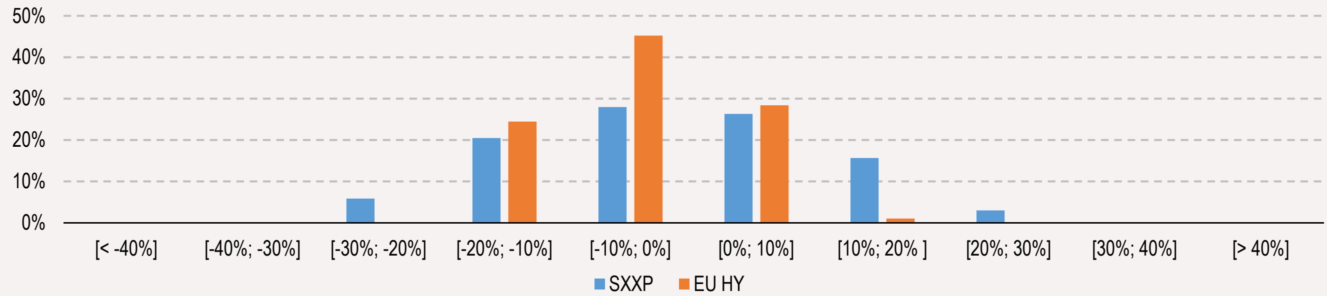
In a cross asset portfolio, the rotation from HY to Equities case holds both in the Eurozone (EZ) and US. However, when considered regionally in relative terms, the EZ shows more upside.

2/ Fair value - US HY vs US Equity



Source: Amundi Research, Bloomberg, Standard & Poor Website, January 2021, X axis reports portfolios expected return range, y axis reports the frequency of the probability distribution.

3/ Fair value - EU HY vs EU Equity



Source: Amundi Research, Bloomberg, Standard & Poor Website, January 2021, X axis reports portfolios expected return range, y axis reports the frequency of the probability distribution

Methodology: Expected returns (and fair values) forecast distributions based on scenario simulations generated from our internal macro forecasts and the financial regime probabilities as resulting from our Advanced Investment Phazer. Simulated distributions capture asymmetries, upside and downside risks underlying the central scenario for all asset class universes considered. In the last chart, we show two balanced portfolios (DM and GEM risky portfolios) based on 50% DM HY + 50% DM Equities distribution and 50% GEM HY + 50% GEM equities distribution respectively. Based on our calculation, portfolios showing strong exposure to EM asset classes should outperform DM-based exposure.

Conclusion

Q4 2020 confirmed the economic and financial cycle roundtrip while the 2021 financial recovery regime will ensure further room for risky asset class rotation. We think the economic recovery will entail a gradual but uneven catch-up process. Relapses in the real economy will occur due to virus outbreaks, while policy intervention should help speed things along. In this environment, growth, rates, inflation, monetary and fiscal policies are strongly interconnected, which means an idiosyncratic risk can propagate a systemic one, even if this remains confined to our downside risk scenario.

The most relevant risks to our central scenario still relate to (1) the evolution of the pandemic in Q1 21, leading to further negative growth shocks, increasing default rates and bankruptcies as a result of prolonged economic downturn affecting business and consumer confidence, and (2) execution risks related to ambitious fiscal stimulus plans.

Although a short-term market correction is worth considering, according to our analyses, the risk rotation story remains sustainable over the medium term. After the recent catch-up in the US, we expect higher potential in the EZ when switching from Credit HY to equities. Investment opportunities should continue to be available in the Emerging Markets in the first half of 2021. In light of these considerations, we believe it is appropriate to maintain a risk rotation focusing even more on lagging asset classes and playing this theme at cross-asset level in order to **maintain the right portfolio diversification**.

Finalised on 06 January 2021

Amundi | Research
ASSET MANAGEMENT

CROSS ASSET
INVESTMENT STRATEGY

January 2021 #01

Amundi Research Center

Find out more about Amundi publications research-center.amundi.com

Emerging Private Equity Money Markets Find Monetary Policies Foreign Top-down Bottom-up Exchange Corporate Equities Forecasts Sovereign Bonds High Yield Fixed Income Real Estate Asset Allocation ESG Quant Investment Strategies

Document issued by Amundi Asset Management, "société par actions simplifiée"- SAS with a capital of €1,086,262,605 - Portfolio manager regulated by the AMF under number GP04000036 – Head office: 90 boulevard Pasteur – 75015 Paris – France – 437 574 452 RCS Paris – www.amundi.com
Photo credit: ©MDelporte - iStock/Getty Images Plus - typhoonski

Chief editor
BLANQUÉ Pascal, *Group Chief Investment Officer*

Editor
DEFEND Monica, *Global Head of Research*

Deputy-Editors
BLANCHET Pierre, *Head of Investment Intelligence*
BOROWSKI Didier, *Head of Global Views*

With Global Research contributers
AINOUZ Valentine, *Deputy Head of Developed Markets Strategy Research, CFA*
BELLAICHE Mickael, *Fixed Income Strategist*
BERARDI Alessia, *Head of Emerging Markets Macro and Strategy Research*
BERTONCINI Sergio, *Senior Fixed Income Strategist*
BLANCHET Pierre, *Head of Investment Intelligence*
BOROWSKI Didier, *Head of Global Views*
BRECHT David, *Fixed Income Analyst, CFA*
HUANG Claire, *EM Macrostrategist*
CESARINI Federico, *Cross Asset Strategist*
DELBO' Debora, *Global EM Senior Strategist*
DROZDZIK Patryk, *EM Economist*
GEORGES Delphine, *Fixed Income Strategist*
HERVE Karine, *EM Senior Economist*
LEONARDI Michele, *Cross Asset Analyst*
PERRIER Tristan, *Global Views Analyst*
PORTELLI Lorenzo, *Head of Cross Asset Research*
USARDI Annalisa, *Senior Economist, CFA*
VARTANESYAN Sosi, *EM Senior Economist*

With the Amundi Insights Unit contribution
BERTINO Claudia, *Head of Amundi Investment Insights Unit*
FIOROT Laura, *Deputy Head of Amundi Investment Insights Unit*
DHINGRA Ujjwal, *Amundi Investment Insights Unit*
PANELLI Francesca, *Amundi Investment Insights Unit*

Conception & production
BERGER Pia, *Research*
PONCET Benoit, *Research*