the day after

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Post-crisis narratives that will drive financial markets

Amundi
ASSET MANAGEMENT

History is a cyclic poem written by time upon the memories of man

– Poet Percy Bysshe Shelley, 1792-1822

Author

Pascal BLANQUÉ
Group Chief Investment Officer

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Executive summary

Today, investors have a unique opportunity to observe the spreading of a real virus alongside the viral nature of financial markets and the real economy. As Nobel Prize-winning economist Robert Shiller points out in his book, *Narrative Economics: How Stories Go Viral and Drive Major Economic Events*, "**stories and images are created around new economic events**"[1]. In some cases, these stories are memories of the past and their spreading can have major implications regarding economic and financial markets.

The Covid-19 crisis has thrown up a sequence of images from the past (pandemics, wars, the Great Financial Crisis) that have pushed central banks (CB) and governments to act in unprecedented ways (in terms of magnitude and speed of action). This has defined **the current '*day after*' narrative.**

Financial markets have adapted to this new narrative, pricing in the rosiest scenario of a 'day-after renaissance', but more will be needed in terms of fiscal and monetary support to sustain the recovery moving forward. The Covid-19 fallout on the real economy and society is deep and pervasive: the overall debt level in the system is skyrocketing and some sectors are very unlikely to recover to pre-crisis levels. Rising social and inter-generation inequalities are the enemy to fight to avoid social upheaval.

Politics is the link between public narratives (reinforced in the media and on social media) and **institutional narratives.** The narratives that will emerge amid hot political events — the US presidential election and the debate around the allocation of resources from the EU Recovery Fund being the most relevant — **will set the direction for financial markets.**

Strong narratives can drive market consensus and lead to crowded trades around major themes. When narratives continue to build up, taking a contrarian view can be very dangerous and expensive for portfolio returns. This has been the case in the last few years prior to the rise of the Covid-19 pandemic, when markets were driven by the stimulus narrative (central banks first, Trump fiscal push after). This stimulus narrative continues, coupled with zero interest rates and inflation permanently forgotten in the Covid-19 era, but **investors should be aware that narratives could change quickly.**

Today, the mantra of financial markets is that core bond yields will remain low forever, but this assumption **may prove more fragile than currently anticipated and have significant spillover regarding financial market performance.**

Tackling post-Covid-19 challenges will require further expansion of debt to finance the investments needed to drive changes that could broadly benefit society. High debt levels will require higher inflation and real rates to remain low to favour the repayment of debt.

The assumption that interest rates will remain low forever has translated into an overly exposure to the '*long duration call*' that is implicit in different trades in the market: long US Treasury (UST) trade, long investment-grade credit, long Big Tech equities, long private equity or real estate. In the end, they are all trades playing the same long duration view.

The Fed unlimited QE has pushed UST yields to all-time lows. The Fed's new framework of "average inflation target" means short-term rates should stay near zero during the recovery phase, but this doesn't imply that the long end of the curve cannot adjust to improving fundamentals. Some steepening

1. In the words of Shiller, narrative economics is: "*a theory of economic change that introduces an important new element to usual list of economic factors driving the economy:* ***contagious popular stories that spread through word of mouth, the news media, and social media***".

has already started to materialise, but we could even reach a point when the steepness of this cycle could be greater, as the Fed and the ECB are not going to hike until inflation moves way above their target for a long period of time.

Any disappointment due to a stronger-than-expected recovery or a technical reduction in the size of the quantitative easing (QE) programmes could trigger a sort of 'taper tantrum' and challenge the current assumption on core bond yields. Any increase in rates for whatever reason could make valuations in some segments of the equity market unsustainable, especially in the tech sector. Given the crowded trades in this space, any unwinding of positions could ignite market volatility. **This is the key element to watch for today.**

Currently, inflation is completely off the radar among market participants, but it should be monitored actively as an emerging theme in a world of rising de-globalisation forces and higher debt. **Big data and artificial intelligence could become even more relevant in the investment world,** as they allow for the tracking of these patterns and the use of them to better understand and forecast trends.

Investors should be prepared for a possible change in the narrative. These shifts are arguably the only sequence via which investors can systematically extract value. It will be critical that investors maintain a strong level of flexibility and liquidity to exploit those opportunities arising from inefficiencies and dislocations.

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The crisis and memories of the past

Crises are moments of brutal eruption of memory patterns, and Covid-19 is no exception to this. They are followed by conflicting narratives until some new equilibrium (consensus) emerges. Risk premia are part of this equilibrium and markets react to new representations of the world. Today, we are living through a sequence of events that is giving way to **a new status quo, characterised by extreme fiscal and monetary measures. Markets are adjusting to this new order.**

When the Covid-19 crisis erupted early this year, the story was that of a healthy global economy, with China — or, in a worst-case scenario, Asia — seen as the single dark spot, where virus containment and policy actions might have been enough to restart economic expansion pretty soon. We recalled the 2002 SARS outbreak in Asia, which did not prove particularly worrying at the global level. Markets were sanguine, and global equity markets reached new highs, locally making a V-shaped recovery.

When Covid-19 hit Europe and the United States in early 2020, for the first time in modern history, Western democracies had to implement extreme and previously unthinkable lockdown measures, moving from a sense of safety to one of bewildered uncertainty and lack of control as virus- and economic-cycle forecasts were continuously readjusted based on updated contagion statistics.

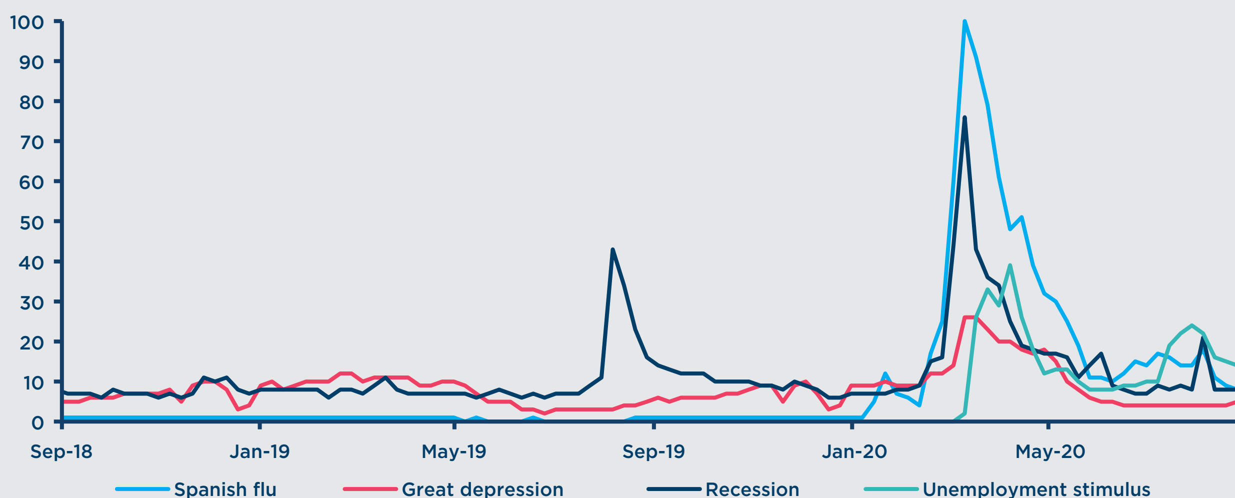
Within the public, memories recalled war, the economic damage of the recent Great Financial Crisis (GFC), the 1918 Spanish flu pandemic, and the Great Depression of the 1930s.

As lightening crashed through the blue sky, this translated into the fastest bear market in history, with some minor overshooting on the downside, as policymakers stepped in firmly to save the day.

Influenced by fresh GFC memories, central banks restarted massive easing policies through balance sheet expansion, pushing their purchases to new levels to avoid the delays that occurred in the past.

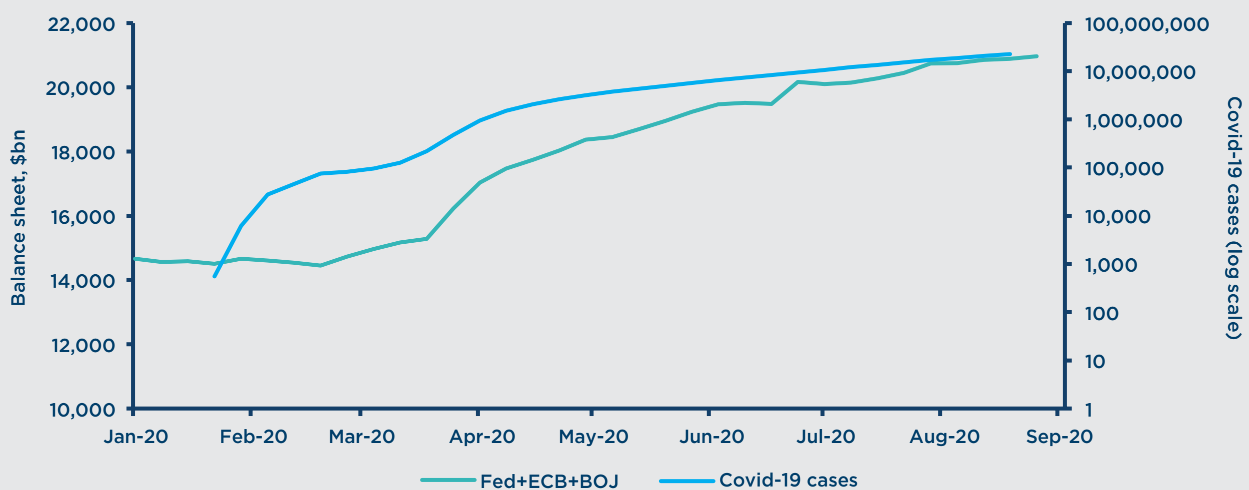
Unlike in 2008, fiscal policy joined forces with monetary policy in supporting the economic reconstruction, as politicians turned their attention to previous recessions that had damaged their economies and electoral trust,

Figure 1: Google searches during the Covid-19 pandemic



Source: Amundi. Analysis on Google Trends, all categories worldwide. Numbers on the graph are normalised and presented on a scale from 0–100, where each point on the graph is divided by the highest point, or 100. A downtrending line refers to decreasing relative popularity of a search term and not necessarily to a shrinking total number of searches for that term. Data as of 4 September 2020.

Figure 2: Virus and central banks' balance sheets: a common pattern



Source: Amundi on Bloomberg data as of 4 September 2020.

giving rise to populist parties. **The taboo of fiscal expansion appears to have faded even in Germany, where the government is breaking radically with its 'black zero' policy of the past.** Driven by urgency, the EU is taking key steps regarding the integration process. In this new order, **monetary and fiscal policies are increasingly intertwined,** leading to de-facto debt monetisation and **blurring the boundaries between free and 'controlled' markets.**

Among the public, these measures have helped to tone down the most negative images, but the virus cycle is not over and **a new and frightening image of a renewed recession potentially driven by a second wave of the pandemic could gain traction rapidly.**

The narrative puzzle of the 'day after' and its market implications

Markets tend to focus on the actions of policymakers. Hence, the extreme monetary and fiscal measures have led to a new picture of a 'day after' renaissance, based on **memories of the previous successes of CB in fighting the GFC.** When looking at the stories circulating among market participants (using Bloomberg stories as a source), the unprecedented size of the monetary and fiscal stimuli has been outpacing memories of the global economic damage induced by the pandemic.

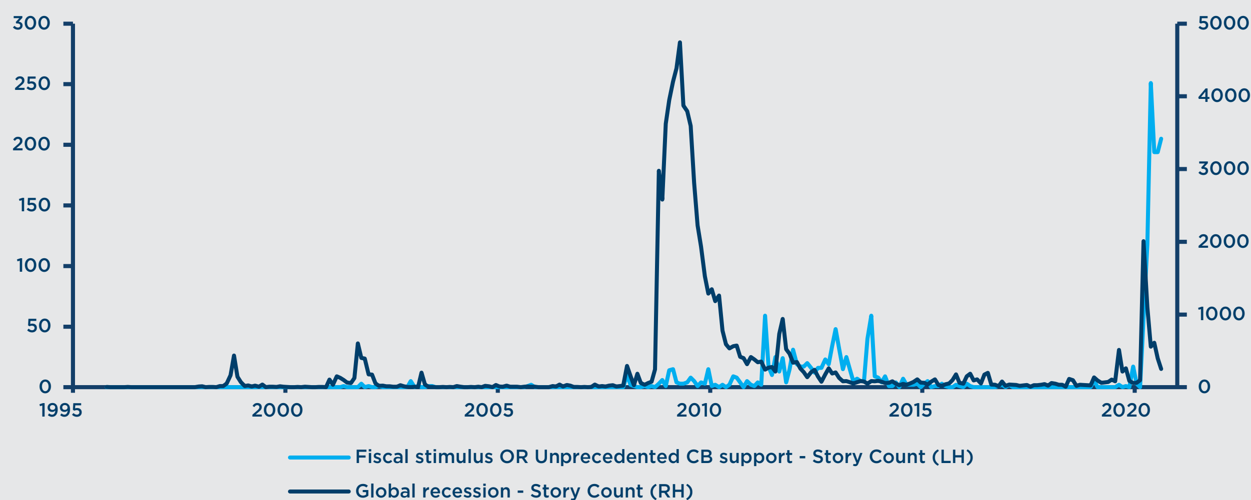
Therefore, markets started to price in the rosiest scenario: the end of the worst part of the virus cycle, the possibility that an eventual second wave could be weaker than the first one, and a treatment and vaccine arriving fast and becoming broadly available before a new pandemic pushes the economy into a renewed series of lockdowns. **The general idea is that the economic freeze is almost over and that it is time to look forward.**

This is what has pushed US equity markets to new all-time records, together with a recovery in lagging markets such as Europe, Japan and EM. This has reignited the frantic search for yield that has been directed to those assets benefitting from the CB purchasing programmes.

"However, the road towards recovery could be bumpy."

On the one hand, it will take time and policy action to erase these memories and replace them with less risky ones. This is what **policy action aims to do: replace bad memories with better images and expectations.**

Figure 3: The fiscal and monetary narrative has outpaced global recession fears



Source: Amundi analysis on Bloomberg data as of 4 September 2020.

The shock to the real economy has already materialised, but a possible second-round impact of the virus would affect the credit cycle and defaults would follow. So far, only those companies most directly affected by lockdown measures have gone bankrupt, but the zombie company[2] phenomenon is skyrocketing. The trade-off between solvency and liquidity continues. There will likely be more victims, and many downgrades are still to come. **Expectations that the pandemic is over may be too optimistic, and any slip-ups could heat the markets up again.** Although some risk assets are back to pre-Covid-19 situations, the world is more fragile. The overall debt in the system is higher; younger generations will have to pay for it. There is a wider gap between performances and valuations for high tech/digital companies and the rest of the market. Some sectors are very unlikely to recover to pre-crisis levels. Higher unemployment and rising social inequalities are risks to consider going forward, when the support of temporary fiscal measures will fade.

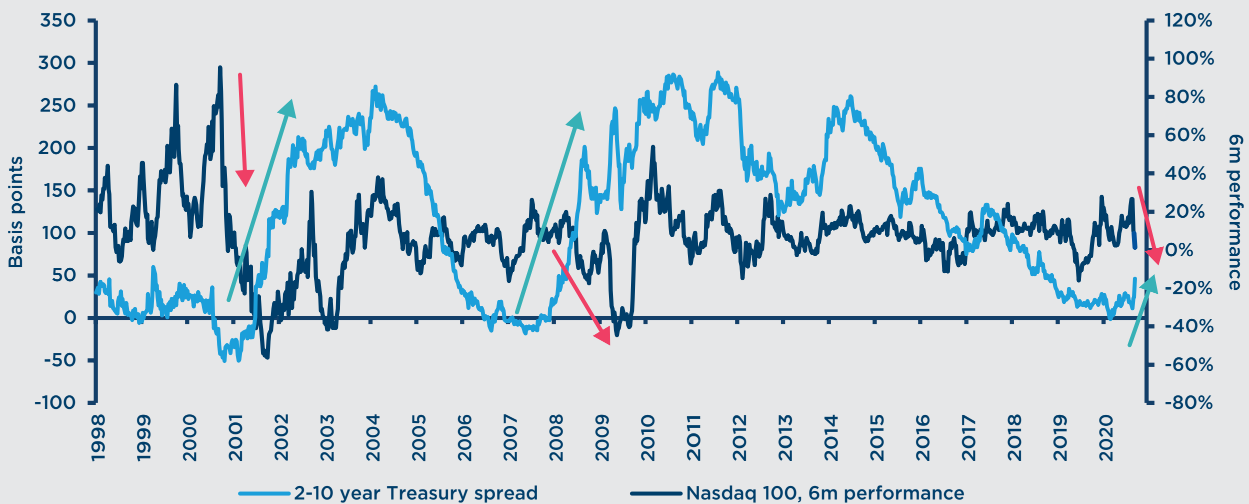
On the other hand, should a vaccine be successfully tested and introduced, and the recovery start to materialise stronger than expected, the current market backdrop could be challenged. **Today, the mantra is that core bond yields would stay anchored forever, but this belief may prove more fragile than thought. This could have a significant impact on markets and in particular regarding areas where crowded trades have been building up recently.**

The assumption on rates translated into an overly exposure to the '*long duration call*' that is implicit in different trades not only in the direct long US Treasury trade, but also in long investment-grade credit, long Big Tech equities, long private equity or real estate. In the end, they are all trades playing the same long duration view.

The Fed's unlimited QE has pushed UST yields to all-time lows. The bank's new framework of "average inflation target" means short-term rates should stay pinned near zero during the recovery phase, but this doesn't imply that the long end of the curve cannot adjust to improving fundamentals. The Fed's balance sheet expansion has stopped just because it's too big. Similarly in Europe, the ECB's balance sheet is now equivalent to 54% of euro area GDP and at this stage the net issuance ex ECB buying will likely be close to zero in the euro area this year and potentially negative.

2. Zombies are companies that earn just enough money to continue operating and service debt but are unable to pay off their debt.

Figure 4: 2-10 Treasury spread and Nasdaq 100 performance (6-month rolling)



Source: Amundi analysis on Bloomberg data as of 4 September 2020.

The implication is that the US Treasury and the Bund curves can steepen on 2s10s or 10s30s horizons.

Some steepening has already started to materialise, but we could even reach a point when the steepness of this cycle could be greater, since the Fed and the ECB aren't going to hike until inflation moves way above their targets for long periods of time.

This would not only have an impact on the bond market. **This is also relevant in the context of current high market valuations, especially in the tech sector.** These valuations are acceptable if interest rates remain low forever or fall further. Any increase in interest rates for various reasons (higher prices as a consequence of supply chain disruption, the news of a vaccine becoming available which would normalise economic activity, or the reduced absorption of huge US debt issuance by the Fed) could drive a repricing of assets.

"Investors should be aware of a butterfly moment in interest rates."

New possible narratives for the long term

Not all stories have the same potential to become viral and impact the economy and markets. The most powerful ones have a human and emotional element and can undergo a mutation that makes them even more contagious, as happens with the spread of a virus.

What is of interest for investors is that multiple narratives, sometimes even conflicting ones, can be generated out of a single event (for instance, the Covid-19 crisis) and that there are also different spheres of circulation for these stories. There are **public narratives,** reinforced in the media and on social media, and there are **institutional narratives,** ie, ways of reading the economic developments that affect policy decisions.

They are interrelated and the great link between them is politics.

Politics cannot ignore real life and public opinion. In the aftermath of a crisis, politics always comes under discussion, as happened with the 2008 Great Recession, which paved the way for a rise in populism globally.

"The advent of populism is what makes narrative economics even more relevant today."

Populism is built around emotional and impactful stories and it can both drive and

be affected by them. **Covid-19 is challenging populism,** as the response to the virus outbreak from current populist leaders has been weak and confused. But, this is just a short-term reaction: what happens next on the political front and with the public reading of the events over the next six to 12 months will be a key driver of 'day after' economic policies.

While governments and central banks have introduced extreme measures, more will be needed to sustain current market valuations. Some risk assets (especially crowded trades) today are priced for perfection, and there is no room for disappointment. Moreover, the risk of policy mistakes cannot be underestimated. When short-term measures to fight unemployment and help companies survive lockdowns are removed, **people will question who has been most damaged by the crisis and who has benefited from it.** Hence, it is vital that the money available is targeted efficiently and that communication is effective, as too much haste to secure electoral consensus could result in a misallocation of capital and ineffective communication could risk revitalising populist or extremist parties.

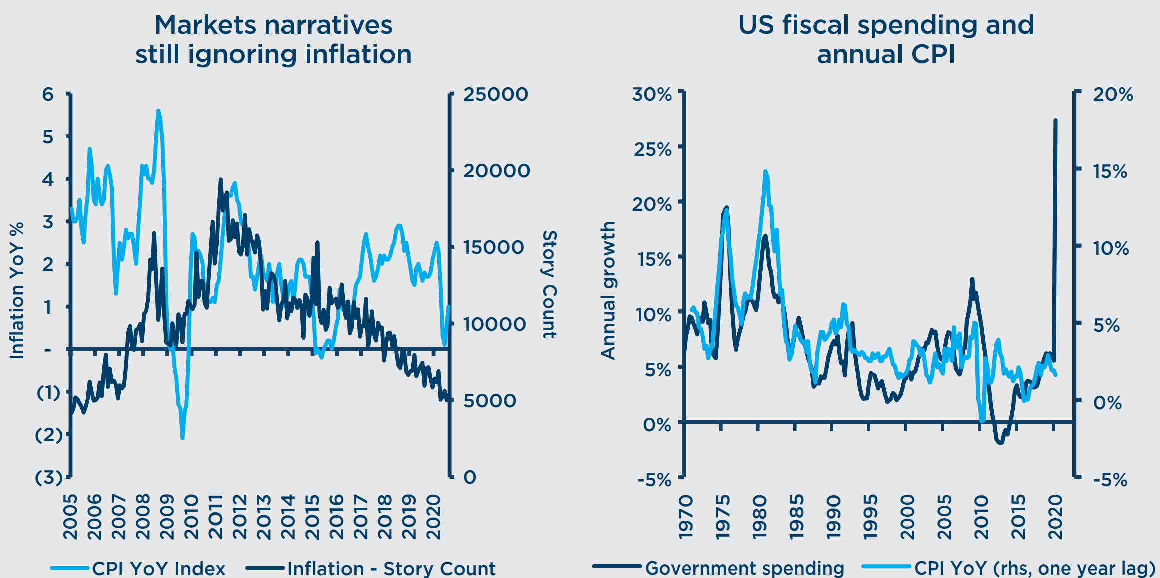
The remainder of 2020 will be crucial in giving directions on the political front, as geopolitics will increasingly take centre stage the farther we move towards the final phase of the US presidential election and the debate around allocation of resources of the EU Recovery Fund. When it comes to the latter, it may not be sufficient to send political signals to populations rising up against elites.

For investors, this means that the political factor (the p-factor) is going to be even more relevant in the 'day after'. Markets tend to follow the institutional reading of the facts, as this is a key driver of economic policies. But in a world of increasing globalisation of information and rising political risk.

> *"Investors should also move to paying attention to popular stories that could have important economic and investment implications."*

With a long-term view, the battle between the images generated at different levels (public and institutional) and the evolving political landscape could end eventually with a new financial regime. The '70s vs '30s opposition is the conflict that will drive the new regime. As has happened in the past, political forces will be key in driving the new

Figure 5: No inflation focus at the market level and relationship between fiscal spending and inflation



Source: Amundi analysis on Bloomberg data as of 4 September 2020.

order. We expect de-globalisation dynamics to be further reinforced in the post-Covid19 world (with re-insourcing of value chains and control of strategic assets by governments), with inequality and social themes emerging even more prominently and climate change becoming in greater focus (see also our previous 'day after' papers).

Tackling post-Covid 19 challenges will require further debt expansion to finance all of the investment that is needed to drive change that benefits society in a broad manner. **This will require inflation to return and real rates to remain low to allow for the repayment of debt.**

Today, the inflation topic is completely off the radar among market participants (see the lack of Bloomberg stories on the topic, Figure 4). The market is not pricing in a revival in inflationary expectations at all.

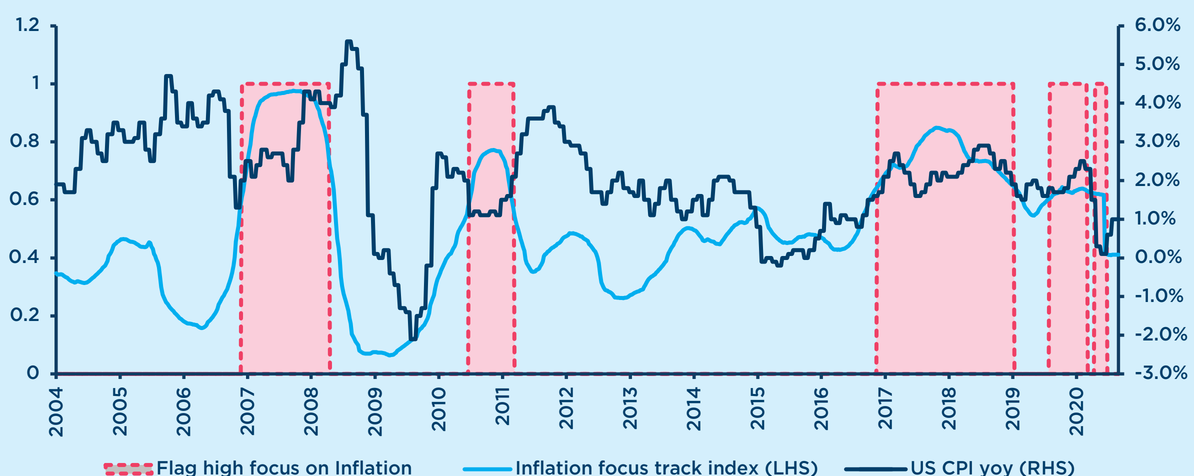
"But narratives can go viral very quickly, leveraged by early evidence."

At the public opinion level, attention to food price dynamics and minimum salaries had already been rising over the last few years and could come increasingly into focus amid possible price increases due to value chain disruptions related to the pandemic (see *Inflation* paper in the 'day after' series).

Box 1: Big data at work to detect early signals of a turnaround in inflation

Regarding inflation, we have been working actively to seek indicators that could help to predict a potential surprise on the upside by collecting a weekly historical series of relevant inflation-related words (ie, CPI, gold&inflation, oil&inflation) from Google Trends, creating our **Inflation Focus Track Index** (see chart). We considered the web popularity of these words, calculated the statistical power embedded in these words to predict price dynamics, and eventually defined a framework via which we mapped periods of time when the web focus on inflation was high and when it was low. This indicator currently signals a temporary stabilisation in the focus on inflation, due to the current recession and fears of new lockdowns.

Figure 6: Inflation Focus Track Index



Source: Amundi Research, Bloomberg. Inflation Focus Track Index is Amundi's Cross-Asset Research proprietary tool based on big data analysis from the web (Google Trends). The relevant text/word combinations for the inflation theme are identified and dynamically tracked according to the popularity of web searches. We detected two relevant regimes (high focus and low focus) to articulate the most appropriate cross-asset investment implications. High focus = flag high focus on inflation in the chart. Data as of 10 September 2020. Time-series data collected at an extremely fine scale.

Eventually, a new narrative of higher inflation might start to emerge and a new order might take a shape similar to that seen in the 1970s (as deglobalisation comes with monetisation of debt).

The shift in narratives and regime shifts are arguably the only sequence during which investors can systematically extract value, as the remaining times they would be faced with more efficient markets that would not allow them to do this. The 'Efficient Market Hypothesis' works on the assumption of there being some market equilibrium.

"When regimes shift, equilibrium regimes and risk premia shift too."

In this adjustment process, investors should avoid strict asset allocation guidelines and keep a **strong level of flexibility and liquidity to exploit the opportunities arising from inefficiencies and dislocation.** The ability to identify the early signs and patterns of these shifts is critical in this respect.

Big data and artificial intelligence are therefore likely to become even more relevant in the investment world, as they open up the possibility of tracking these patterns and using them to better understand and forecast trends. Regarding inflation, for example, with visibility around the structural Covid-19 spillovers being scarce and considering the limited hard data available, investors should look for innovative research techniques in big data, using high frequency indicators that could provide insights that capture early changes and anticipate trends (see Box 1). **For investors, this phase has to be handled with care — they can't ignore the 'day after', but they must also exercise caution and be selective. In the battle regarding images and narratives, those arising related to Covid-19 have not yet disappeared: they are simply in the background. They are likely to resurface as a second-round impact of the crisis unfolds and a new order begins its embryonic phase.**

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Other Contributors

Claudia BERTINO,
Head of Investment
Insights Unit

Pierre BLANCHET,
Head of Investment
Intelligence

Monica DEFEND,
Global Head of Research

Laura FIOROT,
Deputy Head of
Investment Insights Unit

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