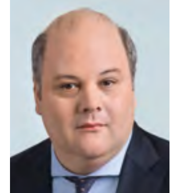
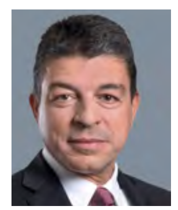
# Key CIO convictions for H2 2023



**Vincent MORTIER**
Group Chief Investment Officer



**Matteo GERMANO**
Deputy Group Chief Investment Officer

### 1. Narrow and uncertain path to growth, with a bottom in H2 2023

The lagging effects of tightening in the real economy will lead to a further deceleration in growth with divergences: a mild US recession, anaemic growth in Europe and more resilience in emerging markets. With low absolute numbers, both on the positive (Europe) and negative (United States) sides, the path ahead remains very uncertain.

### 2. Gradual slowdown in inflation

Inflation is trending lower, but the speed of adjustment is slow as core inflation remains sticky and stubborn. Evidence from past episodes of high US inflation suggests it will take about two years to bring core inflation down by half from its peak level. This is also our view this time.

### 3. Monetary tightening is close to peaking, but do not expect a U-turn

We believe that Fed and ECB rates are close to their cyclical peak and do not expect any cuts for the remainder of 2023, as inflation remains above central banks' targets and the slowdown is pushed back towards year-end.

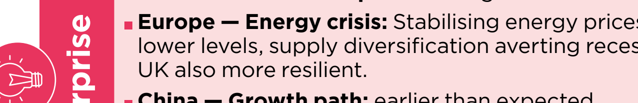
### 4. The growth premium of emerging markets remains wide, with Asia in focus

The resilience in emerging market (EM) growth is leading to a wide growth gap vs. developed markets (DM). We expect Asia to continue to attract investment flows and also to benefit from China and India moving towards more sustainable and inclusive long-term growth models.

### 5. US consumer resilience is a key variable to watch

So far, strong demand has allowed companies to pass through higher costs to consumers, but these benign conditions should fade. Savings will dry up and tighter lending conditions are worsening the outlook for consumers. We expect a deterioration in US sales and EPS.

**H1 2023: mid-year in review**



| | Economy and politics | Financial markets |
|---|---|---|
| Expected | ▪ **United States — Fed pivot:** Inflation on a downward trend, but core inflation sticky, leading to central bank tightening, albeit at a slower pace than in 2022. Fed pause in Q1-Q2 2023.<br>▪ **Europe — Energy crisis:** Energy crisis: weak economic outlook amid energy crisis.<br>▪ **China — Growth path:** Growth path: domestic-driven and reopening. | ▪ Confirmation that **bonds are back,** particularly govies and quality credit.<br>▪ Return of **60-40 portfolios**.<br>▪ **Weak risky assets outlook**, entry points in Q1-Q2 2023.<br>▪ **US equity favoured** against other markets.<br>▪ **Downward US dollar** trend. |
| Surprise | ▪ **United States — Fed pivot:** US regional banks turmoil.<br>▪ **Europe — Energy crisis:** Stabilising energy prices at lower levels, supply diversification averting recession. UK also more resilient.<br>▪ **China — Growth path:** earlier than expected reopening, with modest recovery amid property sector woes. | ▪ **Strong performance of equity markets,** with different narratives across regions: Japanese and European equities, and US tech. Resilience of EM assets excluding Chinese equities.<br>▪ **Widespread stability in credit spreads** despite financial stress.<br>▪ **Downside in commodities**, except for gold. |

Source: Amundi Institute as of 13 June 2023. DM: developed markets. EM: emerging markets. CB: central banks. Economy and politics themes refer to our 2023 investment outlook.

### 6. The cyclical outlook calls for a cautious start to H2

The uncertain macroeconomic outlook and weak corporate earnings growth call for allocations to remain cautious as upside is uncertain and downside risks persist, while risky assets valuations are expensive. The summer earnings season could shine some light on the resilience of companies. A Fed pause, moderating inflation and a persistent recovery in earnings should spark the move into a late-cycle phase and be more favourable for equity markets towards the year-end.

### 7. Rates close to peak support bonds, govies and high-quality credit

Bonds are back is the key 2023 investment theme. Moderating inflation, growth slowing down and a Fed pause will support global high-quality credit, while inflation protection also remains in focus. Investors should stay cautious on high yield, and be mindful of liquidity risk and corporate leverage.

*“Markets are at a critical juncture as central banks are hitting the pause button after the fastest hiking cycle since the ‘80s. Quality is the compass for navigating this phase.”*

### 8. Equity: focus on quality, look beyond mega caps and seek to add to cyclical markets

Concentration risk is high, as US equity market upside has been driven by just a few names. Opportunities are now in the quality space in the search for earnings resilience and in moving down the capitalisation spectrum to avoid areas of excessive valuation. Later in the year, the move towards a late cycle could favour cyclical markets, such as Europe.

### 9. Play emerging markets’ growth advantage in equity and bonds

Attractive valuations, an end to Fed tightening and a possible US dollar depreciation bode well for EM assets. Selection remains crucial, as there are areas of fragile economic conditions and the inflation-monetary policy outlook is mixed.

### 10. Asset allocation resilient to inflation in the spotlight

Inflation remains above normal levels and calls for additional sources of diversification such as private markets (particularly infrastructure) and hedge funds (global macro). Addressing the direction of inflation will be key to tilting sector allocation towards areas more resilient to inflation.

**0**

Number of interest rate cuts expected by the Fed and the ECB in H2.

*Amundi Institute forecast*

**4.2%**

US annual Inflation, 2023 average (CPI, YoY).

*Amundi Institute forecast*

**3.3%**

Expected gap between EM and DM real GDP growth in 2023.

(+4.2% EM vs +0.9% DM)

*Amundi Institute forecast*

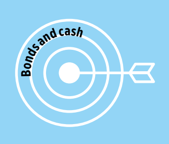
**20%**

Probability of a deeper profit recession in H2 2023.

*Amundi Institute forecast*

# Investment themes for H2 2023

### Bonds and cash in focus




In a decelerating economic backdrop, with rates at their peak in decades, bonds – with a focus on quality – and cash are favoured.

### Search for quality in equities

Ongoing high inflation and deteriorating growth will put corporate profitability under pressure. Quality will be key in search for resilience.

### Emerging markets: from West to East

Investors should embrace a dedicated allocation to Asia, to benefit from its growth advantage (around 70% of global growth is expected to come from Asia this year).

### Inflation-proofed dynamic allocation

This cycle comes with high uncertainty on growth, inflation, and valuation mispricing. This backdrop offers opportunities for a dynamic asset allocation approach.

### ESG themes in focus

Assessing the Net Zero direction and its impact on investment is becoming a key priority at a time when other themes, such as strategic autonomy and food security, are also gaining traction.

# Follow the sequence

We are here

| | H1 2023 | H2 2023 |
|---|---|---|
| **Bonds and cash in focus** | ▪ US bond duration favoured over euro given the more advanced tightening cycle in the United States.<br>▪ Global credit in focus.<br>▪ We have become increasingly cautious on HY. | ▪ Cash, US government bonds.<br>▪ Global credit with a focus on quality, cautious on HY.<br>▪ EM HC bonds and seek entry points in EM LC debt. |
| **Search for quality in equity markets** | ▪ Play quality, value and high dividends.<br>▪ Increasingly cautious on the US, particularly mega caps. | ▪ Seek quality both at a global level and within each region. |
| **Emerging markets: from West to East** | ▪ We started adding to China equity to benefit from China's reopening.<br>▪ Start adding to EM bonds from Q2. | ▪ Start raising EM exposure as currencies should benefit from Fed pause.<br>▪ With a medium-term horizon, build dedicated allocation to Asian assets, particularly China and India. |
| **Inflation-proofed dynamic allocation** | ▪ Play dynamic asset allocation to exploit opportunities from evolving economic backdrop with a tilt towards those assets and sectors more resilient to inflation, namely commodities and risk assets, as inflation moderating but staying above CBs' targets. | |
| **ESG themes in focus** | ▪ Look for ESG improvers, net-zero portfolio construction and, more generally, themes on climate change and socially-oriented strategies. | |

Source: Amundi Institute as of 1 June 2023. CB: Central banks.

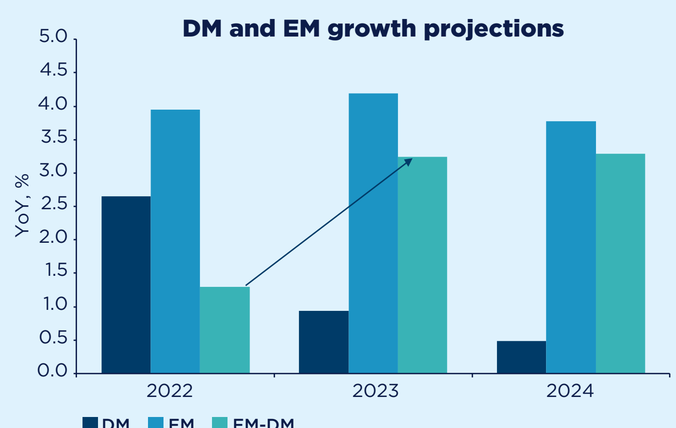
# Uncertain growth path calls for allocation to remain defensive

**Monica DEFEND**
Head of Amundi Institute

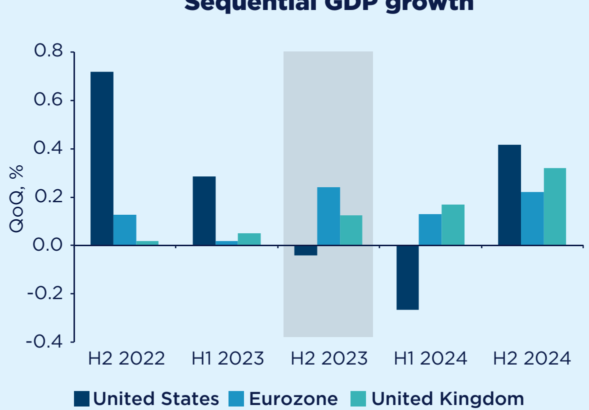
*"It is time to rein in a defensive stance and look beyond the cyclical slowdown to seek opportunities ahead."*

Economic resilience and a smoother adjustment of supply chains and sources **(transformative globalisation)** both in developed (DM) and emerging markets (EM) have led us to upgrade our near-term growth projections **despite the weak global backdrop.** We expect global GDP growth at 2.9% in 2023. DM should slow to 0.9% from 2.7% in 2022, decelerating less than previously anticipated, while EM growth should reach 4.2%, widening the EM-DM growth gap. Despite this, high inflation within a restrictive macro policy setting and a deteriorating geopolitical environment lead us to expect **low overall global growth for 2023.** The growth outlook is even more mixed across regions and countries, especially where upgrades reflect better near-term momentum rather than expected future tailwinds. Monetary tightening is close to a peak, even if its lagged effects are still underway, but we expect a restrictive monetary policy stance to be maintained for an extended period. As such, liquidity should be monitored. Central banks are engaging on two fronts: rate rises to fight inflation and ample balance sheets to preserve the economic cycle and financial stability. **We expect anaemic growth in Europe**, while the UK may also avoid recession, amid strong employment and better tax revenue. High inflation and tight credit conditions should cap household and business spending. Despite below-potential growth, inflation should remain above target up to mid-2024. Despite some resilience, **we expect a mild US recession from Q4 2023** amid tighter credit conditions stemming from ongoing stress in the regional banking sector and the progressive transmission of monetary policy tightening to the real economy. US inflation should remain above target throughout the year.

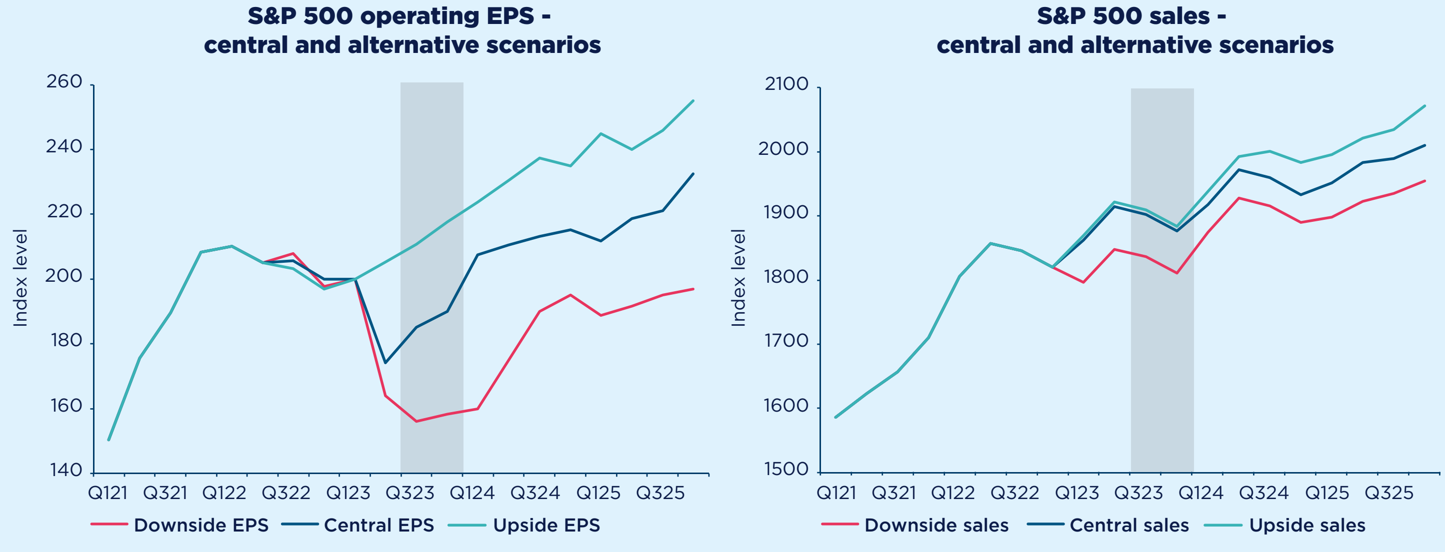
In **EM**, the overall macroeconomic momentum is fragile but resilient, mostly where policy support is stronger. Fiscal support is overshadowing monetary policy support, as most measures to shield consumers from high living costs have not been phased out yet. H2 2023 should see stable, or easier, monetary policy across EM. In **China**, we see 2023 real **GDP growth at 5.7%**, with signs of weakness materialising in housing during May. Overall, EM economic conditions remain fragile, with most economic strength having been front-loaded in Q1 2023.



Source: Amundi Institute. Data and forecasts are as of 13 June 2023.




Source: Amundi Institute, Datastream, Bloomberg. Data is as of 13 June 2023. Forecasts are by Amundi Institute and are as of 13 June 2023. Data is average QoQ growth, not annualised.




Source: Amundi Institute, Bloomberg for the history. Data is as of 31 May 2023. Downside and Central forecasts are from Amundi Institute, Upside is the official consensus from S&P Capital IQ.

Source: Amundi Institute, Bloomberg for the history. Data is as of 31 May 2023. Downside and central forecasts are from Amundi Institute, Upside is the official consensus from S&P Capital IQ.

## Defensive allocation is preferred during a correction phase

The expected economic backdrop should facilitate a continuation of the current **Correction phase** – according to Amundi Institute's Advanced Investment Phazer (see the next page) – in financial markets until year-end, with even stronger conviction given to deteriorating US economic conditions and a profit recession that has not yet hit its trough. Markets have stayed buoyant on Q1 earnings. Amid strong demand, companies were successful in passing through higher costs to consumers, **but these benign conditions should fade for Q2-Q3 earnings**, reflecting a worsening outlook for consumers. We expect a deterioration in US sales and EPS, as we see a mild recession materialising. The next two quarters of the reporting season could lead to a market correction from current levels that could create entry points for equity markets. When it comes to inflation regimes, according to Amundi Institute's Inflation Phazer, H1 2023 saw a shift from the **Hyperinflation regime** (featuring a YoY price change in the US >10%) that prevailed in 2022 to a more benign Inflationary one (featuring a YoY price change at 3-6%). For **H2 2023**, the combination of monetary policy tightening, lower commodity prices, and weakening demand should favour **further price moderation**, particularly in reference to headline inflation. However, the return to a **Normal inflation regime** – featuring YoY inflation changes at 2-3% – **remains uncertain**, as core inflation remains sticky and is expected to remain above central bank targets.

The resulting **asset allocation** suggests a **defensive approach, with gold and duration among the favoured asset classes**, while we keep a cautious stance on risky assets. Looking to 2024, a gradual recovery in H1 is more likely. However, it is too soon to call for a generalised risk-on move, given limited visibility on the extent of the cumulated impact of the financial tightening induced by the Fed rate hikes. **A scenario of moderating inflationary pressures should make current valuations more sustainable.** Upside risks could come from a less-painful-than-expected macroeconomic scenario, with a positive impact on corporate revenues, which are the main driver of any profit recession. Margins should benefit from a producer-price and labour-cost normalisation, alongside a weaker dollar. Downside risks relate to a credit event and its spill-over to corporates and the whole economy.

**Francesco SANDRINI**
Head of Multi-Asset Strategies

*"Low growth and high inflation suggest a cautious asset allocation. Gold and government bonds are favoured over risky assets in H2. Moving into 2024, an improving outlook for earnings could open up opportunities to add risk assets."*

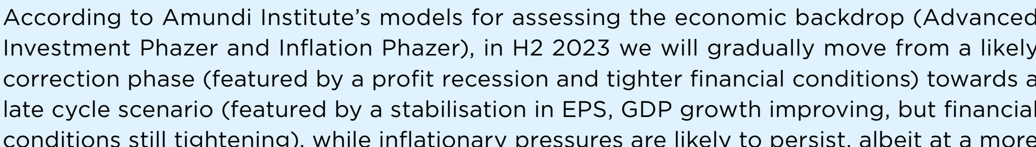
**John O'TOOLE**
Multi-Asset Investment Solutions

# Dynamic asset allocation calls for a cautious start before adding equity

**Lorenzo PORTELLI**
Head of Cross Asset Strategy - Amundi Institute

Amundi Institute's Dynamic Asset Allocation (DAA) seeks to determine the medium-term (6 months to 3 years) optimal allocation, which is determined by assessing:

- **Economic backdrop:** what asset classes can deliver historically according to the expected financial and inflation regime*.
- **Top-down valuation:** what markets are pricing in and not pricing in. This is key to fine-tuning the allocation denoted by the economic backdrop.

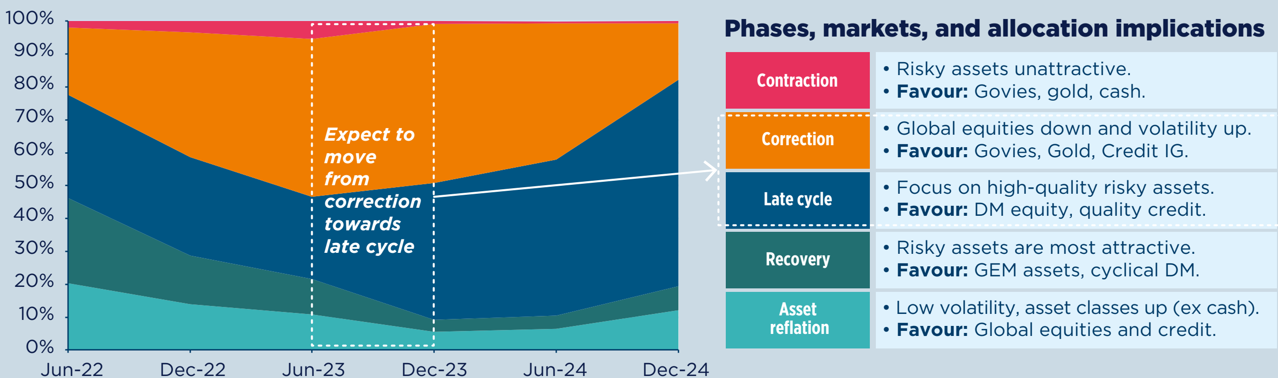


According to Amundi Institute's models for assessing the economic backdrop (Advanced Investment Phazer and Inflation Phazer), in H2 2023 we will gradually move from a likely correction phase (featured by a profit recession and tighter financial conditions) towards a late cycle scenario (featured by a stabilisation in EPS, GDP growth improving, but financial conditions still tightening), while inflationary pressures are likely to persist, albeit at a more moderate pace than in H1 2023. The certainty of uncertainty driven by close probabilities of more vs less constructive market phases, calls for a cautious allocation stance to start with, especially for equity markets where overall valuations are not supportive either. Once markets have corrected part of this overvaluation, or should the economic backdrop move into a late cycle more quickly, this will open opportunities to rebuild the exposure towards risky assets.

## Economic backdrop assessment

### Advanced Investment Phazer (probability of financial regimes):

The model defines five phases based on macro-financial variables and the associated probabilities of their occurrence. For each phase, the model defines the favoured asset classes and their optimal allocation.

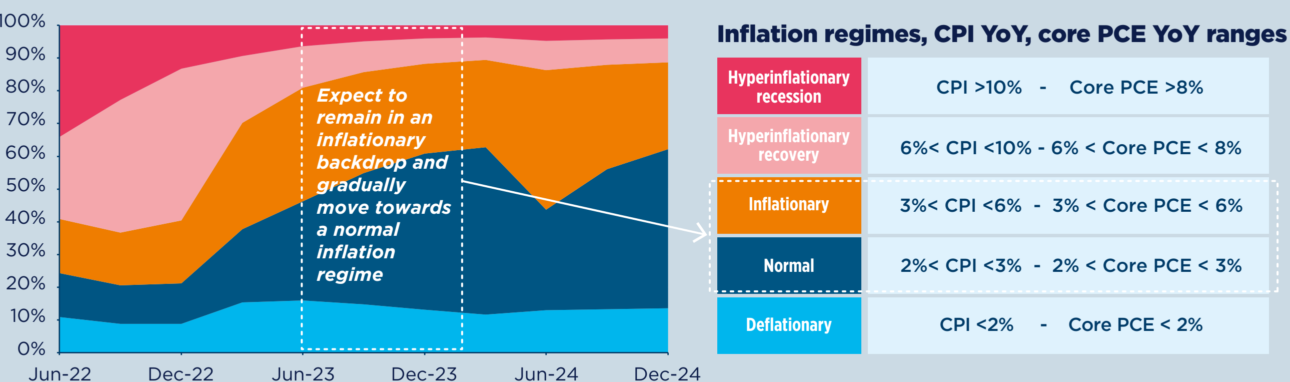



**Phases, markets, and allocation implications**

| Phase | Implications |
|---|---|
| Contraction | • Risky assets unattractive.<br>• **Favour:** Govies, gold, cash. |
| Correction | • Global equities down and volatility up.<br>• **Favour:** Govies, Gold, Credit IG. |
| Late cycle | • Focus on high-quality risky assets.<br>• **Favour:** DM equity, quality credit. |
| Recovery | • Risky assets are most attractive.<br>• **Favour:** GEM assets, cyclical DM. |
| Asset reflation | • Low volatility, asset classes up (ex cash).<br>• **Favour:** Global equities and credit. |

### Inflation Phazer (probability of inflation regimes):

The model defines five phases based on key inflation metrics and determines the probabilities of the occurrence of each phase. A high probability of inflationary phases will call for an asset allocation tilt towards those asset classes and sectors more resilient to inflation.

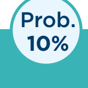



**Inflation regimes, CPI YoY, core PCE YoY ranges**

| Regime | Ranges |
|---|---|
| Hyperinflationary recession | CPI >10% - Core PCE >8% |
| Hyperinflationary recovery | 6%< CPI <10% - 6% < Core PCE < 8% |
| Inflationary | 3%< CPI <6% - 3% < Core PCE < 6% |
| Normal | 2%< CPI <3% - 2% < Core PCE < 3% |
| Deflationary | CPI <2% - Core PCE < 2% |

Source: Amundi Institute, Bloomberg. Data is as of 1 June 2023. **For Illustrative purposes only.*** Discover more on Advanced Investment Phazer: a guide to dynamic asset allocation.

# Central and alternative scenarios

| | DOWNSIDE SCENARIO (Prob. 20%)<br>**Financial crisis triggers global recession** | CENTRAL SCENARIO (Prob. 70%)<br>**Persistent stagflationary pressure** | UPSIDE SCENARIO (Prob. 10%) <br>**Economic resilience** |
|---|---|---|---|
| Geopolitics | ▪ Worsening Ukraine war impairs commodity trade.<br>▪ More protectionism and increased retaliation to protectionist measures. | ▪ Ukraine war. Risk of escalation in the short run. De-escalation is likely in late 2023 / early 2024.<br>▪ China-US tensions.<br>▪ More protectionism (IRA and its 'siblings').<br>▪ OPEC+ imposing a floor on oil prices. | ▪ De-escalation in Ukraine.<br>▪ Lower energy / food prices. |
| Inflation and policy mix | ▪ Sticky core inflation leads to tighter financial conditions.<br>▪ CB hike more than expected.<br>▪ Financial stress.<br>▪ **Two sub-scenarios** with different paths for key rates: **modest recession:** inflation risks may still prevail; and **strong recession:** large rate cuts as soon as H2 2023. | ▪ Inflation: gradual slowdown. Sticky core inflation should get closer to target by end-2024.<br>▪ DM CB close to the peak, no rate cuts in 2023.<br>▪ Fed funds rate back to 3% by end-2024 (-225bp). ECB: no rate cut before end Q1 2024.<br>▪ Monetary policy is more mixed across EM: many EM have hit peak rates.<br>▪ EU fiscal policies to tighten. US fiscal impulse to stay negative due to spending caps over the next two years as a result of the debt ceiling deal. EM fiscal space constrained amid prudent stance. | ▪ CB status quo, key rates higher for longer. |
| Growth path | ▪ More widely spread recessionary outlook (global growth below 2%). | ▪ Subdued global GDP growth (below 3%), with divergences: anaemic growth in Europe, mild US recession, reopening rebound in China.<br>▪ Tightening credit conditions will impact DM economic activity in H2 2023.<br>▪ Sub-par growth expected in 2024 in most DM.<br>▪ Growth gap still favours EM in 2024, but with no further widening. | ▪ In case of pronounced cyclical disinflation, we could see a faster-than-expected return to potential growth in 2024.<br>▪ IMF- or ECB-type scenario. |
| Climate change | ▪ Climate transition measures postponed, with more climate events hitting supply chains. | ▪ Climate transition measures postponed with more climate events impacting supply chain and food security. | ▪ Climate change policy and energy transition are top priorities. |

# Risks to central scenario

HIGH ← PROBABILITY → LOW

| Market impact | 25% | 20% | 20% | 20% | 10% |
|---|---|---|---|---|---|
| | **Geopolitical risk and war escalation** | **Global economic slowdown and deep profit recession** | **Persistent stagflationary pressure (US / Europe)** | **Macro financial risks triggered by tighter credit and liquidity conditions** | **US government shutdown**** |
| + | **Positive** for DM govies, cash, gold, USD, volatility, defensive assets and oil. | **Positive** for cash, JPY, gold, quality vs. growth, and defensives vs. cyclicals. | **Positive** for TIPS, gold, commodity FX and real assets. | **Positive** for US Treasuries, cash and gold. | **Positive** for EUR, JPY, CHF and Bund. |
| - | **Negative** for credit, equities and EM. | **Negative** for risky assets and commodity exporters. | **Negative** for bonds, equities, DM FX and EM assets. | **Negative** for credit. | **Negative** for US Treasuries, US equities, and risky assets. |

Source: Amundi Institute as of 16 June 2023. DM: developed markets. EM: emerging markets. CB: central banks. USD: US dollar. EUR: Euro. CHF: Swiss franc. JPY: Japanese yen. TIPS: Treasury inflation-protected securities. FX: foreign exchange markets. **Despite the debt ceiling agreement, Congress still has to adopt a budget for FY2024, which starts on 1st October. Budget negotiations should be tense and the possibility of a shutdown at a later date cannot be ruled out. Otherwise, fiscal policy can become more restrictive than expected.

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