#15 / July 2022

PENSION FUNDS LETTER

Confidence must be earned

Amundi ASSET MANAGEMENT

Building together smart solutions to face a challenging environment

Alexander PREININGER
Global Head of Institutional Coverage

Sandrine ROUGERON
Global Head of Corporates and Corporate Pension Funds Clients

EXECUTIVE SUMMARY

Stage 2022: Cycling on

As holidaymakers resume their familiar summer breaks and crowds return to the Champs-Elysées to cheer on the final stage of the 2022 Tour de France, elsewhere established customs and trends seem less secure. One could say that a period of transition has been ongoing for some time. But in 2022, a new phase clearly unfolded, one unique to our times, but at the same time also hugely familiar. A phase where everything takes on a geopolitical slant.

From this new vantage point, we can see a slow but steady reorientation of the world, upturning previous “certainties”. Economic policies are being reconsidered as the low-inflation regimes seen in Europe and the US in the past few decades have vanished, just as established geopolitical alliances are turned on their heads. Amongst all this, the shift to a low-carbon economy has gone from a pressing issue to an absolute priority as we try to live with the effects of climate and with the energy shortages due to the current conflict in Ukraine.

Our latest edition of the Amundi Pension Funds letter examines what this shift in regimes will mean for pension funds.

Throughout history, economic and financial markets have been driven by long-term regimes, which are brought to a close when the imbalances borne by society become too extreme. The existing regime gives way to a new one. This was last the case in the mid-1980s when the Great Inflation, which defined the 1970s, gave way to the Great Moderation, a regime of low market volatility and inflation.

We now face what we at Amundi have named the Great Transformation. This new regime will be defined by higher inflation, lower growth and increased global desynchronisation and fragmentation. The social inequalities brutally exposed by the pandemic and the escalating climate crisis represent huge challenges to society and will require colossal investment to overcome.

Meanwhile, the shifting international frameworks have led Europe to rethink its reliance on imports and its ability to compete in the digital revolution and in innovation overall. But untangling decades of interconnected supply chains and finding the funding for a project of this scale is no easy task. What will this ultimately mean for pension funds?

However, the major transformation of our times remains climate change and the essential mitigation and adaptation efforts needed to avoid climate disaster. What impact will these measures have on asset prices? Amundi Institute looks at how these factors impact return forecasts and what the consequences will be for investors.

Finally, we conclude with our regular look at what the recent market movements have meant for pension funding ratios and take a closer look at the uncertainty and implications brought by soaring inflation.

Pascal BLANQUÉ
Chairman Amundi Institute

The Regime Shift is underway: Pension Funds should get prepared

This year's Amundi World Investment Forum, Amundi's annual thought leadership event, was titled "The Great Transformation – Building Resilience in a Time of Unknowns"[1]. But what is this Great Transformation? Long before the Covid-19 pandemic swept the globe, Amundi had been advocating that a great transformation, a deep regime shift, was underway.

The shift started off with a gradual decrease in global trade with several recent events only acting as accelerators: notably the Covid-19 pandemic and, more recently, Russia's war in Ukraine. The world (and thus financial markets) is no longer as we know it and investors will need to come to terms with this. Higher inflation and stronger fragmentation are only some of the (interconnected) elements being reshaped.

Macroeconomic Uncertainty

On the economic and financial side, the reshoring of certain value chains in the wake of the Covid-19 crisis and the rise in inflation contribute to uncertainty in economic cycles. This can lead to an unstable scenario of fiscal dominance, in which expansionist fiscal policies are combined with accommodative monetary policies to alleviate debt burdens. Such a situation puts central banks in the difficult position of having to contain inflationary pressures and maintain financial stability at the same time.

Different exposures to inflation across countries and the diverse levels of room for manoeuvre available to central banks also support the fragmentation argument. **Fragmentation is indeed likely to increase** since central banks are reacting differently to surging inflation. Varying principles and rules indicate the end of monetary consensus, just as central banks are facing inflation levels unprecedented in recent history. Moving away from a traditional rule-based system towards a more discretionary approach will cause divergences and increased fragmentation.

Geopolitical Fragmentation

The global order is undergoing a **period of evolution**, with different groups of countries emerging in the international arena with the United States, the European Union and China leading the main regional blocs.

Synchronous economic cycles are expected to be a thing of the past. **Regional cycles will be more frequent** and there will be a need to pay increased attention to country-level risk. The world is heading in a direction of lower economic interdependence and following a trend of regionalisation, notably as a result of the pandemic. Indeed, the organisation of production processes based on efficiency and cost optimisation has become obsolete. Disruptions in value chains observed during the Covid-19 crisis have raised awareness of the risks of depending on countries in different zones of influence.

Geopolitical trends are also likely to shape international trade relations. **Trade in goods is no longer considered on the basis of economic benefits alone.** The war in Ukraine, as well as the economic sanctions imposed on Russia by the West, demonstrate that countries may seek to use trade or financial relations to achieve political goals.

On the European front, in the medium to long term, the increased focus on strategic autonomy and energy independence is expected to strengthen the position of the Euro area and its currency. However, in the short run, **high stagflationary risks** will be an obstacle to Europe's recovery.

While the current crises and their economic consequences have heavily impacted emerging markets, most emerging countries now have healthier economies (e.g. better current account balances with higher foreign reserves) compared to 2013 and have embarked on reform cycles. However varying degrees of exposure to inflationary pressures and differing conflict-related economic impacts point towards even **greater fragmentation in the emerging world.**

1. https://forum.amundi.com/

Adapting to a regime shift: opportunities and implications for pension funds

One opportunity created by this global fragmentation is the **increased value of international diversification:** there is no consensus amongst central banks with regards to how to handle inflation, and therefore global returns will turn out to be **less correlated** than in the previous regime, especially in fixed income. Also, in a regime characterised by high and rising inflation, **real returns will take centre stage,** as investors look for sources of positive real returns and for exposure to assets that are positively correlated to inflation. In this respect, the first assessment will concentrate on **real, safe asset returns** – including bonds and bills.

Given this new regime, investors including pension funds will need to adapt. Amundi suggests always keeping in mind these three principles, based on long-term trends and lessons from the past:

1. **Safe assets will prove less safe** than was previously believed and will require investors to broaden their investment universe in the search for inflation protection. For example, in the core bond allocation, government bonds will need to be reconsidered based on the **different economic cycles and geopolitical risks,** while selective emerging market bonds and inflation-linked bonds should be integrated.

   Moreover, **"bondification" of equities will be an attractive space:** stocks with bond-like features (high earnings visibility and low debt) could become part of the "safe" core asset allocation.

2. **Global equities** (especially value/quality tilted) and **real estate** deserve a higher allocation and should see greater benefits from **international diversification.** In a world characterised by fragmentation (e.g. dispersion in cross-country returns) and low real returns for safe assets, risky global assets, including emerging markets, will represent higher value and will hold overall lower risk due to increasing diversification benefits.

3. The **correlation of safe assets** versus risk assets is turning positive, as the inflation factor drives both asset classes. As the common driver of this correlation dynamic is inflation, investors will need to turn to **assets providing higher diversification benefits** and exhibiting low correlation to both bonds and equities.

With contributions from
Sofia SANTARSIERO
Business Solutions and Innovation at Amundi

Pierre BLANCHET
Head of Investment Intelligence,
Amundi Institute

European strategic sovereignty: what price self-sufficiency?

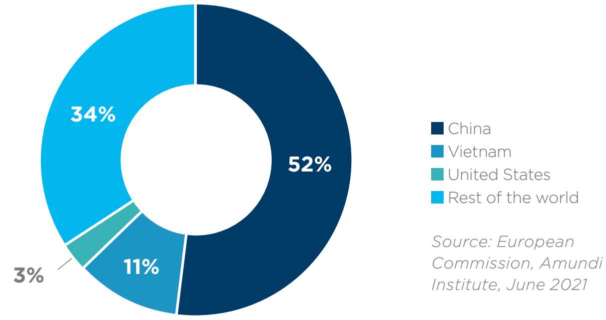
More than just a question of security and defence

Traditionally, European strategic autonomy has been addressed as part of a geopolitical and military security framework, and was therefore seen as a political challenge. However, the Covid-19 pandemic and the war in Ukraine have also highlighted the importance of considering European strategic sovereignty from an economic point of view. **Autonomy and sovereignty are separate, but related topics;** Whilst autonomy refers to security and defence, sovereignty concerns the broader economic and societal need for decreased external reliance. In the recent past, Europe's integration efforts, for example proposals for a common military power or integrated capital markets, were met with political resistance. However, Brexit, the pandemic and, most recently, Russia's war with Ukraine have reignited the desire for further European integration and sovereignty. Nonetheless, **strategic sovereignty does not imply isolation and complete self-sufficiency, but rather a decreased and more manageable reliance on outside forces.**

137 products have been identified where the EU is highly dependent on external suppliers, 34 of which are unlikely to be replaced by domestic production such as oil and certain raw materials[2]. **China currently accounts for over half of EU imports of products where external dependency is very high** (Figure 1). Even though the EU is a global leader in the pharmaceutical industry, it is nonetheless highly dependent on India for pharmaceutical components. As another example, the EU is almost completely dependent on Taiwan for its semiconductor needs. If Europe wishes to achieve strategic sovereignty, it will be essential to resolve these supply chain issues. In essence, the concept of **European sovereignty aims to address the need for selective reshoring of production as well as supply chain diversification.**

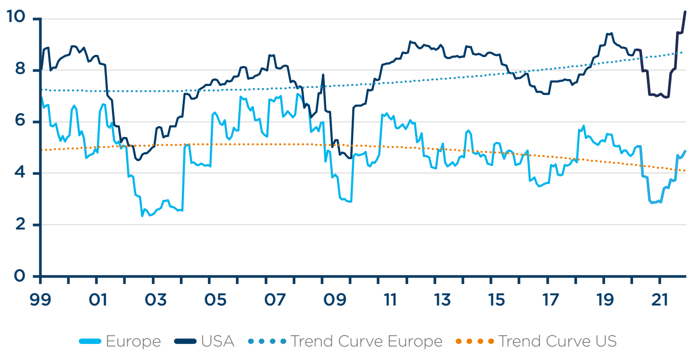
Although geology constrains Europe's domestic production capabilities for commodities, the strong reliance on external suppliers for other sectors is partly the result of a lack of investment incentives. The aggregate return on invested capital for Europe has been significantly behind US peers since 2010[3] (Figure 2), and as a result, R&D expenditures have lagged in comparison with that of other developed markets[4]. **Europe does not have a shortage of capital or ideas, but the investment gap needs to be closed** in strategic sectors in order for strategic sovereignty to be achieved. Another explanation for the European investment gap is **the regulatory framework, which currently favours investment in government debt rather than private enterprises.** But given the scale of the necessary investment to achieve strategic sovereignty, public funds will not suffice and investment from private sectors will be essential.

Figure 1: Origin of imports of 137 products for which the EU is dependent (in value)



Source: European Commission, Amundi Institute, June 2021

Figure 2: Return on invested capital in the US and Europe
(Average aggregate since 1999)



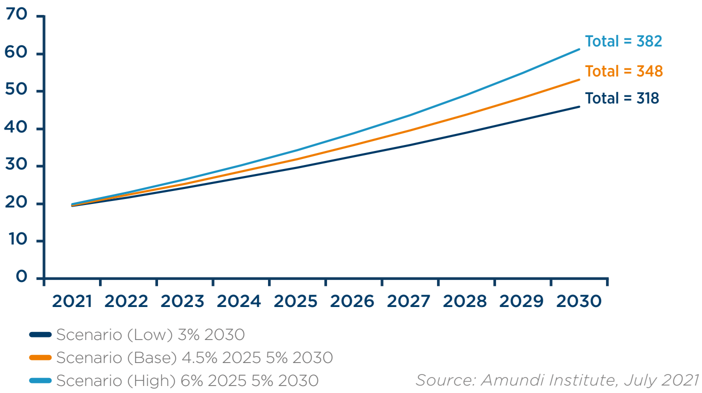
Source: MSCI, Amundi Institute, January 2022

2. Source: COMMISSION STAFF WORKING DOCUMENT. Strategic dependencies and capacities. Updating the 2020 New Industrial Strategy: Building a stronger Single Market for Europe's recovery.
3. MSCI & IBES
4. Source: World Bank, Amundi Research, data from 1996 to 2019 i.e. before the pandemic

Industry challenges and structural obstacles

One sector particularly susceptible to European strategic autonomy ambitions is the **semiconductor** industry. The European Commission's ambition is to reach a 20% global market share by 2030[5]. To ensure Europe meets this target, **€300bn to €400bn of investments will be needed by 2030** (Figure 3). Today, no country is self-sufficient in the complete semiconductor value chain, and dependencies on other countries are likely to remain in the foreseeable future[6]. Given the high barriers to entry, Europe's existing strengths, strong supplier concentration and Chinese-Taiwanese geopolitical risk, **Europe plans to direct significant investment towards semiconductor manufacturing facilities** by 2030.

Figure 3: Annual EU R&D and CAPEX expenditures projection (€, billion)



Source: Amundi Institute, July 2021

Another industry that will experience significant disruption as a result of Europe's drive for strategic sovereignty is the energy sector. Europe runs a large trade deficit when it comes to energy, with a combined magnitude of $147 billion in 2020. In 2021, Russian natural gas accounted for 40% of EU gas consumption[7], and as widely debated, the invasion of Ukraine has only highlighted the need for Europe to decrease its reliance on Russia. This is reflected in the recent launch of the REPower Europe initiative, which aims to end reliance on Russian fossil fuels before 2030 and accelerate the energy transition initiated with the European Green Deal. In the longer term, a combination of strategic sovereignty ambitions and Net Zero Emissions targets will **decrease external energy reliance** through increased renewable energy generation and advanced power grids, **requiring over $3.2 trillion in additional sector investment** by 2050[8]. The European energy sector is at the forefront of disruption as part of Europe's net zero objectives, as well as its strategic sovereignty efforts.

More broadly, Europe is losing ground in the race for global innovation, mainly as a result of the investment gap. Another reason Europe struggles to keep up with innovation levels seen in other markets is a lack of digital infrastructure and technology implementation. Although European firms are green innovation leaders in areas such as hydrogen, wind energy and grid enhancement, they lag behind the US when it comes to adopting digital technologies[9]. According to a 2021 European Investment Bank report, **firm size and high fixed costs are holding back European digital adoption[10].**

One last key issue that needs to be addressed in order to close the investment gap in strategic sectors is the deepening of capital markets. Europe is heavily dependent on bank financing, and banks are not the preferred choice to finance innovation or growth based on intangible capital. Systems that rely solely on banks for financing have been found to be associated with lower levels of growth[11]. Furthermore, equity financing is better suited for financing risky investments. Studies from the European Investment Bank have indicated that **one of the main factors explaining low levels of innovation in Europe is the lack of equity financing[12].** The regulatory framework should aim to incentivize investments in equity and corporate debt, rather than public debt.

The role of European pension funds

Ultimately, for Europe to achieve strategic sovereignty, **the investment gap in strategic sectors needs to close.** In addition, European innovation will need to be stimulated through digitisation as well as deeper capital markets. Although strategic sovereignty efforts will receive significant policy support, public funds will not suffice and private capital will need to be deployed. This process has already started: As an example, Italian private pension funds have been advocating for alignment of their asset allocation with the Italian National Recovery and Resilience plan relating to green and digital projects, and consequently, strategic sovereignty[13].

With an AUM of €3.1 trillion[14] alongside their long-term investment horizon, **European pension funds are in a unique position to facilitate Europe's sovereignty aspirations** through having the means to provide capital to strategic sectors, fostering digital adaptation and assisting in the transformation of capital markets.

With contributions from
Tom DENEKE & Sofia SANTARSIERO
Business Solutions and Innovation at Amundi

5. SIA & BCG April 2021
6. Chaillot paper: European Sovereignty, Chapter 2, July 2021
7. IEA, How Europe can cut natural gas imports from Russia significantly within a year, 2022
8. Bruegel, How much investment do we need to reach net zero?, 2021
9. EIB, Building a smart and green Europe in the COVID-19 era, January 2021
10. Source: EIB, Digitalisation in Europe 2020-2021: Evidence from the EIB investment survey, July 2021
11. ECB, Bank bias in Europe: effects on systematic risk and growth, May 2015
12. Source: EIB, Key findings retooling Europe's economy, 2018
13. IPE, Italian private schemes demand full autonomy to invest in line with EU recovery plan
14. ECB, June 2021

Pascal BLANQUÉ
Chairman Amundi Institute

Monica DEFEND
Head of Amundi Institute

Keeping up with Climate Change

Integrating key climate change mitigation into Amundi's Capital Market Assumptions and asset allocation process.

Climate change is arguably the most critical long-term challenge faced by humanity. It is also a key element for investors to factor in when building long-term economic and market assumptions. The changes driven by the energy transition will **require a complete rethinking of asset class returns forecasting** and have ramifications for investors both now and in the years to come.

The rebalancing of energy sources across the globe will drive the transition towards a greener economy. But this process will not be linear and we will see **increasing divergences across regions and countries** depending on the starting position and the policies adopted.

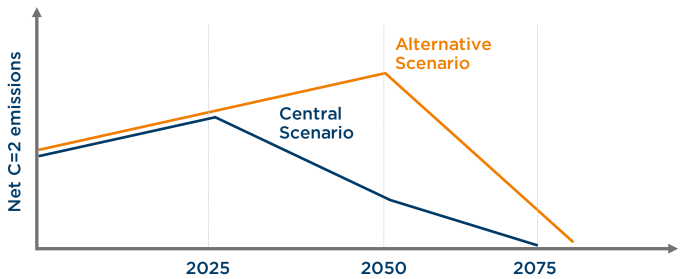
Exposure to physical risks, such as extreme weather events or gradual changes in climate, and transition risks stemming from climate policy adoption, changes in consumer preferences or technology evolution will also affect countries with varying degrees of severity.

Monetary and fiscal policies will need to tackle these risks, as their initial impact on the economic outlook (through business disruption, higher commodity prices, migration, amongst others) could transfer to the markets where they could generate a perverse feedback loop through market losses and credit defaults which would damage economic outlook even further.

Changing the way we think about forecasting

With this in mind, we have developed a **new climate-aware "Central Scenario" base case with a 30-year horizon.** In this scenario we expect climate policies to be slowly introduced from 2025, but that this will proceed in a muddled fashion, incorporating some risk of delays. Under such a scenario, the energy transition improvements **will not be sufficient to meet the 1.5°C above pre-industrial levels** goal, although we assume that global warming will remain below 2°C.

Figure 1: Net CO_2 emissions under the Central and Alternative scenarios



Source: Amundi Institute

We have also defined a more adverse "Alternative Scenario" that serves as a "what if" exercise. This scenario sees a significant lack of coordination among global institutions running mitigation policies that make it difficult to limit global warming to below 2°C. Ultimately, the transition to a Net Zero world would be delayed and the macroeconomic environment would worsen as the risks increase significantly.

To assist our analysis, we also modelled an "Old World" environment where no specific climate policies or climate impact are considered.

Old world	Central scenario	Alternative scenario
No specific climate politics or climate impact considered.	Incorporates some risk of delay. Slow introduction of climate policies starting from 2025, but proceeding in a muddled fashion. 1.5° C goal not reached, but limited to 2°C. Net Zero CO_2 emission targets are not met by 2050.	Divergent schemes introduced for a more efficient and quicker phase out of oil, but at a higher cost. Lack of global coordination among institutions. Insufficient policies to meet the 2°C target.

Source: Amundi Institute

While the Central and Alternative cases present limited physical risks (e.g. chronic high temperatures, disrupted agricultural productivity, higher sea levels or cyclones and wildfires), compared to a "hot-house" scenario of significant and irreversible global warming, they cause moderate to high transition risks that will unevenly affect growth and inflation dynamics.

- **Central scenario:** the impact on growth is marginal, while the erosion of household purchasing power by high carbon and energy prices (and overall higher inflation) will already be high in the next decade, particularly for high carbon users.
- **Alternative scenario:** while the delay in green policy adoption will limit the impact on inflation, fragmentation and the speed of the process will introduce more uncertainty, penalising investments and therefore growth particularly for countries with higher emissions (China, India).

> *"While the Central and Alternative cases present limited physical risks, compared to a "hot-house" scenario of significant and irreversible global warming, they cause moderate to high transition risks that will unevenly affect growth and inflation dynamics."*

What outcome do we predict in economic terms?

Overall, the **energy transition** will further exacerbate regional and country divergences, as the **five main macro implications** from an active Net Zero 2050 climate policy will all bring higher fragmentation.

1. **Ballooning debt will be the climate legacy.** Debt will be needed to finance the infrastructure and electrification process behind the green transition.
2. **A green commodities super cycle.** To address climate change, a targeted taxation policy will push the costs of coal, natural gas and oil higher forcing their replacement with renewables.
3. **The era of green quantitative easing begins.** Central banks will provide the necessary support to finance government debt, limit the cost of capital and mitigate higher rates through green QE.
4. **Heterogeneities across countries will be further exacerbated.** Higher production costs and a less efficient production function will have different impacts on countries depending on their initial energy mix and future paths.
5. **Expect lower earnings and a less market friendly environment.** We expect lower earnings-per-share growth, low government bond yields, wider spreads and less complacent valuations driving lower absolute returns overall.

What's changed in our approach?

Rethinking long-term equilibria

Despite numerous uncertainties and the limitations of models, we believe that revising the forecasting approach to incorporate the climate dimension is key to making better-informed asset allocation decisions.

Asset Class	New Climate-Aware Forecasting Methodology – main changes vs previous methodology
Government Bonds	Nominal interest rates continue to be a function of economic fundamentals (neutral rate, growth and inflation), with the explicit addition of adjustments for supply/demand factors (**government debt patterns**) and unconventional monetary policy (**central banks**' balance sheet management).
Credit	Corporate spreads are the results of nominal rates and investment profitability and therefore are affected by the **new EPS growth model** and by **private investment growth.**
Equities	Equity returns are a function of capital gains (driven by EPS growth, real GDP growth, inflation, government yields and unemployment) and income (dividends and buybacks). **New EPS growth model combines top line with bottom line** making the dependency on costs explicit (PPI, ULC).
Real Assets	Real asset returns depend on **new expectations for public listed assets, growth, inflation** as well as on assumptions for **volatility and liquidity risk** premiums.

Source: Amundi Asset Management CASM Model, for illustrative purposes only.

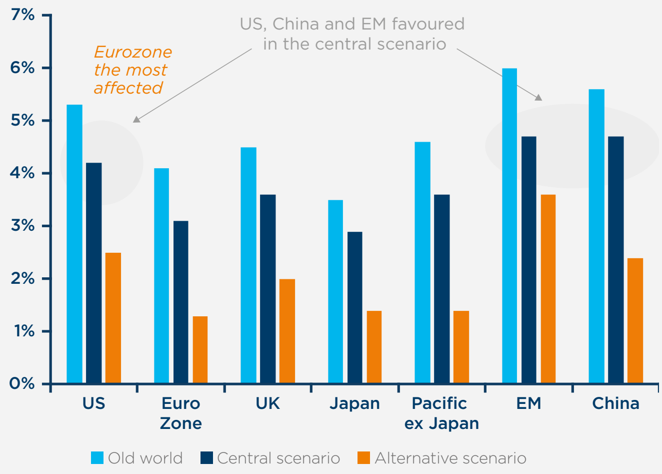
What do the new climate-aware asset class assumptions mean for investors?

The age of green transition will offer less directional, but more relative value opportunities

Over a 10-year horizon, **expected returns will be somewhat lower under the new Central Scenario** compared to the Old World environment, while the Alternative Scenario will be disruptive especially for equity markets. The transition will imply a general risk premium erosion with differences across asset classes.

- **Asset allocation:** investors will have to focus on real returns amid higher structural inflation. Equities are preferred to bonds but with **lower returns versus the past.** Higher country/sector divergences and companies' sensibility to energy prices will increase the dispersion of returns and offer stock picking opportunities.
- **Bonds:** green asset reflation will be possible via monetary policies aiming to facilitate the transition. This will support green bonds and EM bonds.
- **Equities:** some Value sectors will be favoured (Energy, Materials, Financials) – which is a change from the previous decade – with a Quality tilt, as Quality has more stable EPS generation, and the usual Growth sectors in the US (IT, Communication Services), which will be a continuation of the past ten years. The contribution of dividend yields to total expected returns will be increasingly relevant.
- **Real assets:** in a world of higher inflation and structural upward pressures on raw materials and huge infrastructure investment needs, **real assets will be favoured** and deserve a greater allocation. Infrastructure is likely to benefit most, followed closely by Real Estate.
- **Hedging:** as the alterative scenario (currently a low probability) will have a significantly negative impact, any events pushing in that direction may cause spikes in volatility and risk-premia repricing. Investors should stay watchful and keep structural hedges in place.

Figure 2: EPS annualised growth (30yr horizon)



Source, Amundi Institute. Data as of 27 of January 2022

*In our central scenario, EPS annual growth for the next 30 years is expected to decrease by 20% relative to the Old World. The Alternative Scenario will see an **impressive 58% average decline in EPS growth.***

In conclusion, whilst development is still needed, particularly in terms of availability and transparency of data, standardisation of methodologies and new regulation, these analyses provide a clearer understanding of the scale of the challenges we are collectively facing. It also allows us to identify factors to pave a way forward and to lead discussions around best practice, which will ultimately help improve portfolio outcomes and risk-management.


Jean-Xavier BOURRE
Head of OCIO Investment Strategy Advisory

David NIDDAM
Multi-Asset Business Development, Head of Insurers, Corporate and Pensions Solutions

Pension funding ratios: Standing firm amid rocky markets, but beware rising inflation

	31/12/2018	31/12/2019	31/12/2020	31/12/2021	31/01/2022	28/02/2022	31/03/2022	30/04/2022	31/05/2022	30/06/2022
Netherlands	103.60%	104.30%	100.20%	114.30%			118.80%	122.80%	122.4%	
UK	95.70%	99.20%	95.50%	107.70%	109.10%	108.40%	111.40%	114.00%	118.90%	
US	86.10%	86.80%	87.90%	95.50%	92.10%	94.50%	95.10%	94.90%	94.50%	93.90%
German CTA	67.30%	67.90%	69.10%	77.00%						

Sources: - UK data: Purple Book, PPF S179 funded status - Netherlands data: Dnb - US data: Aon Pension Risk Tracker. Please note that Aon Pension Risk Tracker is estimating the FR during the year and is updated during Q1 of each year using the actual funded status reported by the S&P 500 companies at year-end. As such, end of December 2021, the funded status update resulted in about a 2% jump in funded status, compared to the estimations published in the PF Letter #1. - German CTA data: FactSet, based on average pension exposure of German corporates of EUROSTOXX 600 for 31/12/18 until 30/12/20. Amundi estimate from 30/06/21.

Since our publication in March 2022, funding status of DB pension funds have continued to improve in Europe whilst stabilising in the US. This move was driven by adverse market conditions with risky assets recording historically poor performances, whilst increases in rates and credit spreads (fixed income markets came under pressure following hot inflation prints, central bank action and rising concerns over economic growth) had an overall positive effect on the funding ratios due to the balance sheet being typically only partially hedged to interest rates.

Q2 2022 Market review

The second quarter of 2022 was another difficult period for the markets with the majority of assets losing ground: equities, sovereign bonds and credit experienced significant losses whilst the US dollar and some commodities such as oil were among the few exceptions. **Developed market equities experienced one of the worst halves of the year since the 70's** and government bonds have also been hit. Markets have been affected by **increasing recession risks** and by **inflation proving more persistent** and requiring a more aggressive pace of rate hikes from central banks than investors were expecting just a few months ago. The rate hikes, together with the energy shock, increased the likelihood for the economy to go into recession, favouring the decline in risk appetite.

In June, we have seen negative returns across the board (with the exception of Chinese equity) and even commodities have struggled after a strong start in early 2022. The main catalyst during the month was the much stronger than expected US CPI print which triggered another selloff as it drove investors to think that the Fed would be forced to hike rates even more aggressively to rein in inflation. This was ultimately followed through at their June 15th meeting when they hiked by 75bps for the first time since 1994. Looking more closely at the equity markets, global developed and emerging markets were both negative in the second quarter and in June. In Q2 the MSCI World Equity index experienced a -16.2% depreciation in net USD total return terms (-8.7% in June).

Q2 2022 Regional breakdown

- Leading the way: the **UK** (benefiting from the large weighting of commodity stocks and low weighting to expensive technology stocks) and **Japan** (Bank of Japan's relatively dovish attitude and Yen devaluation supported the markets despite a deterioration in economic momentum),
- Followed by **Europe**, despite delivering the worst performance in June due to concerns over global growth, inflation and the ECB's ability to contain it
- The **US** had the second worst quarterly performance since the Global Financial Crisis in Q4 2008 due to multiple signs pointing to slower growth together with high inflation prints and a more aggressive pace of rate hikes from the Fed affecting investor sentiment
- **EM** lagged due to a macro momentum that stayed negative but stable and an environment still mildly favouring commodity exporters across the regions

Sovereign bonds lost ground on both sides of the Atlantic and the decline in European sovereigns was one of the worst in the last 20 years. Treasuries also suffered increasing their YTD losses. Inflationary pressures and tightening financial conditions hit government bonds with markets pricing in further increases in interest rates on top of what has already been announced. Central banks are acting aggressively to control inflation whilst higher borrowing costs together with the squeeze on consumers are affecting economic growth.

During the quarter, **US yields** rose with longer maturities seeing the largest moves, whilst in June short maturities rose the most and the curve flattened. **On the European side,** the German Bund experienced a steepening over the quarter. The spread between 10-year German Bunds and 10-year Italian BTP's moved from approximately +149bps at end-March to +193bps by the end of June under pressure due to a hawkish ECB and higher yields. **In the UK,** yields rose during the quarter and the curve steepened despite some flattening moves in June. In the **credit markets**, the European iTraxx Main credit index widened by approximately. +46bps during the quarter, while the high yield Crossover Index widened by almost 250 bps and approximately +142bps during June.

As growth concerns come into focus, corporate bonds increasingly tended to price in a deteriorated environment, with valuations of some segments not far from implying a recessionary scenario. At the same time, messages from central banks remained hawkish on the need to react to higher-than-expected inflation adding to growth concerns.

A closer look at the inflation conundrum

With uncertainty about rising inflation being greater than it has been for several decades, a number of defined benefit pension plans face pressure on their liabilities.

For nearly 15 years, central bankers and governments have been fighting deflationary pressures. Since the pandemic, massive stimulus, economic reopening, followed by the Russia-Ukraine crisis and worldwide disruptions in supply chains have sent a shock that **may have altered the inflation paradigm for good.** As prices spike higher, uncertainty regarding the inflation path is reaching record levels. Illustrating the difficulty of foreseeing the future path of price rises, market expectations for Eurozone and US annualised inflation rates over the next 10 years have ranged from 0.57% to 2.95% and 0.8% to 3.2% respectively over the last 3 years. This range is far greater than we have seen in the past.

Whilst many DB pension funds do not hold significant inflation exposure, a number of them are exposed directly or indirectly in variable proportions:

- The reference to benefits at retirement date may not be directly indexed to inflation, but instead indexed to a function of salaries,
- Via the same mechanism, member's contributions – if any – may be also sensitive to inflation,
- Pension indexation formulas post-retirement can include inflation indexation or not and be subject to inflation caps and floors,
- The reference to inflation is determined based on contract specifics which may change over time and from one jurisdiction to another (e.g. RPI reform in the UK).
- Last, but not least, actuarial assumptions (usually anchored on very long-term horizon) may be different from implicit market inflation forecasts (which are usually more reactive).

Experience has shown that non-lasting inflation moves have not usually been well reflected in the (long-term by nature) actuarial assumptions of the accounting valuation of the liabilities. Consequently, there is often **a lag in the recognition of inflation sensitivity on liabilities** simply because 1) measures do not necessarily capture it 2) inflation may only gradually translate into future service costs and 3) the published year-on-year funding ratio may not be immediately impacted.

In this context, it is fair to note that many of Europe's and US' defined benefit pension funds still have a mind-set forged by years of persistently low inflation. Pension funds have chosen not to hedge their portfolios against inflation, other than the natural hedges that they may have from investments in bonds, equities, commodities, and real estate.

Many DB pension managers have used the correlation between the interest rates and inflation moves (e.g. for a balance sheet with partial interest rate hedge, the nominal funding ratio increase would compensate a deteriorating real funding ratio in a rising rate environment) or the potential inflation resilience of some asset classes (e.g. equities or real estate) as a partial hedge against inflation. **Another reason why some DB plans do not hedge their inflation exposure perfectly is that it would require reallocating cash from performance assets to inflation hedges,** which could hurt their ability to reach asset liability equilibrium. Indeed, in some cases, if the liabilities do not reflect inflation movements (as mentioned above), hedging may generate a perception of undue risk due to a valuation difference of assets and liabilities (rather than an actual financial risk).

However, these considerations are often technical or short term. For most pension funds, the accounting valuations will have to reflect the financial impact at some point, and the correlation between rates and inflation is likely to be variable. Furthermore, **the new inflation paradigm may be structural and last longer than expected.** Typically, the average correlation between 10 years rates and 10 years inflation in the Eurozone has been approximatively 25% over the last decade.

Rising inflation is already affecting some pension schemes funding ratios, even if trustees believe they can simply bear its consequences. In fact, an analysis of their assets and liabilities would reveal that inflation is one of their major risks and a lack of action could prove detrimental down the road.

This situation leads to several questions for pension funds. Firstly, does the plan's inflation exposure make sense within the context of the rest of their strategic asset allocation, i.e. is inflation a good risk to bear compared to those of other asset classes? Secondly, to what extent can pension funds rely on their assets to hedge inflation, i.e. do they believe real returns will remain stable or improve? And lastly, if it is decided that inflation should be hedged, what is the best way to do it?

Advertising

The Great Transformation

Building Resilience in a Time of Unknowns

The 2022 Amundi World Investment Forum, which took place in Paris on June 9th and 10th 2022, explored how policymakers, financial services and investors can rise to the challenges of our times.

Watch former US Secretary of State, Hillary Clinton in conversation with Amundi CEO, Valerie Baudson.

Find out what renowned panellists including historian Niall Ferguson, economist Olivier Blanchard and Nobel Prize winner Daniel Kahneman think about the issues and trends facing the investment industry today.

Discover all the AmundiWIF22 Highlights

Discover

CROSS ASSET Investment Strategy

CENTRAL & ALTERNATIVE SCENARIOS (12 TO 18 MONTHS HORIZON)

Monthly update

We keep the probabilities of our central and alternative scenarios unchanged vs. last month. The new wave of Covid-19 and stagnation in the Eurozone are adding growth uncertainty over the short-term.

DOWNSIDE SCENARIO 30%

Renewed slump toward stagflagtion

Analysis

- **Long-lasting war in Ukraine** is hurting confidence and activity, and pushes commodities and energy price higher for longer and disrupting supply.
- Russia cuts gas supplies to Germany, which enters a recession in 2023.
- **Covid-19** resurgence leads to global renewed mobility restrictions and bottlenecks disrupting supply chains.
- Both triggers lead to an **economic downturn** while **inflation** remains elevated and uncontrolled.
- **Several EM** default and public debt sustainability concerns in DM.
- **Renewed monetary and fiscal accommodation** to suppor t the economy, possibly a further step in financial repression.
- Inflation amid slower growth, forces some **Central Banks** and the ECB in particular, to **deviate** from their guidance and potentially lose credibility.
- Policies and investments designed to fight **climate change** are postponed and/or countries policies are disorderly implemented.

Market implications

- Favour cash, USD and US Treasuries
- Play minimum-volatility strategies
- Gold
- Commodities and energy

CENTRAL SCENARIO 60%

The great divergence

Analysis

- The **war in Ukraine** is hitting confidence and maintains elevated commodities and energy prices.
- **Covid-19 is an endemic disease**, with random contagion waves (China); global activity holds up, but supply-chain bottlenecks to persist.
- **Rising growth divergence:**
  - Global growth progressively abate to trend in 2022, opening 2023's to downside risks.
  - Rebound expected in China in H2, after the GDP contraction in Q2
  - Stagnation or technical/short-lived recession in EZ and the UK
  - The US economy is resilient, but expected to slow down towards subpar growth in 2023 (rising recession risk).
- **Headline inflation is peaking**, but will remain elevated. High commodity prices, supply-side bottlenecks and rising wage pressures will push core inflation up in some regions (e.g. the EZ).
- **CBs follow different paths:**
  - Fed to continue to hike rates aggressively (short run); but to adopt a more dovish stance in H2
  - BoE in a soft hiking cycle
  - ECB to hike rates 3x in H2, but no room for a real tightening cycle (recession risk)
  - PBoC to keep an easing bias
  - Bond yields to move higher but to stay low for longer
- **Fiscal policy:** to smooth the shortterm impact of energy prices (through targeted measures, notably in Europe).
- **Climate change** disrupts the commodity cycle and adds to stagflationary trends.

Market implications

- Lower risk-adjusted real returns expected
- Contained steepening of US Treasuries yield curve as well as EZ and EM
- Inflation hedge via gold, linkers and equities
- EM: Short-term caution, long-term real income and growth story intact

UPSIDE SCENARIO 10%

Inclusive and sustainable growth

Analysis

- **End of the Ukraine war** and sanctions are gradually withdrawn. Lower energy and commodity prices and inflation falls back quickly.
- **Endemic recedes** faster than anticipated, despite variants.
- Extra savings and wage rises fuel **consumption** with low erosion of corporate margins.
- **Productivity gains** thanks to digital and energy transitions and structural reforms
- **Inflation** remains under control and CBs are gradually normalising.
- **Higher nominal and real interest rates,** due to stronger investment and less savings.
- **Debt is sustainable** thanks to strong growth and a gradual shift towards fiscal discipline.
- **Inclusive growth** and effective fight against inequality.
- **Climate change** policies and energy transitions become first priority.

Market implications

- US Treasuries curves bear steepen
- Favour risky assets with cyclical and value exposure
- Favour linkers and equities as an inflation hedge

Geopolitic · *Covid-19 related topics* · *Growth and inflation expectations* · *Monetary and fiscal policy* · *Recovery plans or financial conditions* · *Solvency of private and public issuers* · *Economic or financial regime* · *Social or climate related topics*

CROSS ASSET Investment Strategy
AMUNDI ASSET CLASS VIEWS

	Asset Class	View	1M change	Rationale
EQUITY PLATFORM	US	=/+		Recession is not our base case scenario, but the continuing policy tightening by the Fed amid high inflation could have ramifications for growth, and accordingly corporate earnings. Consumption and labour markets remain strong and we are selective and prioritise value, quality and dividend oriented stocks. However, we avoid expensive growth and mega-caps.
	US value	+		The sell-off over the past month failed to curtail value's outperformance but we believe investors should be selective, explore companies in less cyclical segments and maintain a quality bias. Businesses that can return excess cash to shareholders in the form of dividends, etc., in times of high inflation should be preferred, with a strong bottom-up analysis.
	US growth	-		As the repricing in equities and rates continues, we think growth names whose valuations depend on cash flows way into the future could be further dragged down. While valuations have fallen in areas such as technology, they are still not cheap and hence we remain cautious overall in growth.
	Europe	-	▼	The Russia-Ukraine war is exacerbating pressures on inflation and could weigh on demand in the region, thereby affecting corporate earnings (and thus valuations). In this environment, we remain watchful in the near term, and believe businesses with strong balance sheets and the ability to pass rising costs on to consumers should be able to preserve profits.
	Japan	=		A deceleration in global growth could weigh on the export-driven Japanese market but a weak yen may be supportive for the country's equities. We are neutral in light of the cyclical nature of country's market.
	China	=/+	▲	As the country moves towards a healthy domestic consumption-driven growth model, the desynchronization of China from the global economy, supportive policies and the economic reopening paint a better picture. We are constructive on mainland shares and remain selective.
	Emerging markets	=		We remain prudent even though we see attractive valuations after the recent repricing. The case for selection and fragmentation is high as we look for commodity exporters (Brazil, UAE) and names based on strong domestic demand. Overall, we are valuation conscious and continue to prefer value over growth.
FIXED INCOME PLATFORM	US govies	=		As the Fed continues on its aggressive tightening trajectory, the pressures on core yields are twofold, coming from economic growth and higher Fed rates. We remain close to neutrality for now with a marginal negative tilt, and remain ready to adjust this stance depending on the evolution of terminal rates and inflation. We are limiting our view on TIPS.
	US IG corporate	=/+		We remain mildly positive on US investment grade, particularly on higher-rated credit as it offers attractive carry and the country displays strong consumption and resilient labour markets. Corporate fundamentals are also strong due to the ability of companies to pass through higher input costs to consumers. However, valuations are not cheap.
	US HY corporate	=		Amid a focus on liquidity and company-specific factors, we are neutral on HY. We are watching carefully for any potential spread widening caused by the Fed's aggressive monetary stance and any eventual tightening of financial conditions.
	European govies	=		Economic uncertainty and fragmentation risks, coupled with high inflation and a tightening ECB, warrant a close to neutral stance on duration in core Europe. However, we remain flexible and tactical in our approach across the European curves, and are closely monitoring the policy path. On peripheral debt, we are neutral. We await more clarity on the ECB's new framework to prevent fragmentation as the central bank aims to tighten policy without hurting economic growth.
	Euro IG corporate	=		Persistent uncertainties over growth, the ECB's hawkish overtures and concerns over earnings (due to high input costs) cloud the outlook a bit, even as corporate fundamentals remain robust for the time being. Investors should consider adding high-quality liquid securities over highly leveraged names.
	Euro HY corporate	=		While default rates are low for now, if the economic environment worsens we could see liquidity issues cropping up. Thus, with an aim to look for resilient balance sheets, we distinguish between HY names on the basis of liquidity and quality risks. Overall, we do not like taking directional exposure in the asset class.
	China govies	=/+		Chinese bonds continue to offer diversification opportunities to global portfolios. This, coupled with the PBoC's mild easing stance, should be positive for government bonds.
	EM bonds HC	=/+	▼	We are slightly positive on HC bonds, with a preference for HY, where we believe valuations are attractive versus IG. However, we keep a solid bottom-up selection bias.
	EM bonds LC	=		We see divergences in the LC universe, with a bias towards Latin America (commodity exporting) and caution on Asia. We are particularly cautious on EM FX due to higher US rates and the potential move towards safe havens.
OTHER	Commodities			In times of inflation, commodities offer solid diversification potential. We are mildly positive on oil amid expectations of supply scarcity, which should offset the moderation in demand in the medium term, even if there is near-term volatility in prices. Our 3m target for WTI is $105/bbl.
	Currencies			We see no reason for the USD rally to halt in the near term and believe the EUR/USD may reach close to parity (6m target maintained at 1.02) on the back of a hawkish Fed, productivity gains in the US and slower economic growth in Europe.

--- -- - = + ++ +++
Negative view Neutral Positive view
▼ Downgrade vs previous mont
▲ Upgraded vs previous month

Source: Amundi, as of 28 June 2022, 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.

To go further: The Amundi Research Center

Amundi Institute

In an increasing complex and changing world, investors need to better understand their environment and the evolution of investment practices in order to define their asset allocation and help construct their portfolios. This environment spans across economic, financial, geopolitical, societal and environmental dimensions. To help meet this need, Amundi has created the Amundi Institute. This independent research platform brings together Amundi's research, market strategy, investment themes and asset allocation advisory activities under one umbrella; the Amundi Institute. Its aim is to produce and disseminate research and Thought Leadership publications which anticipate and innovate for the benefit of investment teams and clients alike. To find out more, please visit: **research-center.amundi.com**

ESG Thema

Thematic Papers

Shifts & Narratives