CENTRAL & ALTERNATIVE SCENARIOS (12 TO 18 MONTHS HORIZON)

Monthly update

We change the narrative and the probabilities of the scenarios in line with our 2022 Outlook. The central scenario assumes that Covid becomes endemic with multiple waves albeit manageable, fiscal levers remain significant and tied to monetary policy and growth comes back to potential in 2023.

DOWNSIDE SCENARIO 15%

Renewed slump toward stagflation

Analysis

- Several risks precipitate an **economic downturn**, whose depth depends on the nature and intensity of the shock.
- **Upward price pressures fade**, as global demand falls and labour markets deteriorate.
- **Renewed monetary and fiscal accommodation**, possibly a further step in financial repression.
- Inflation to resurface later, forcing **CB to deviate** from their guidance and lose credibility.
- **Possible triggers** include China's hard landing, Covid-19 resurgence, financial shocks, de-anchoring inflation expectations, climate-change-related natural disasters and policy mistakes.

Market implications

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

CENTRAL SCENARIO 70%

Bumpy road, regional divergences

Analysis

- **Covid-19** becomes an endemic disease, with random contagion waves
- **Growth** catch-up in 2021-22 converges to trend in 2022-23. Soft patch in H1 2022 due to China's slowdown and accelerating inflation
- Persistent **inflation** pressures due to supply-side bottlenecks and to rising wage pressures.
- **Monetary policy asynchrony**: Fed to taper, BoE could hike rates, ECB on recalibration mode, and PBoC on an easing bias. Rates to stay low for longer.
- **Fiscal policy**: withdrawal of some accommodation, but support will be needed for the energy transition.
- **Climate change** bites into growth and inflation by disrupting the commodity cycle and adding to stagflationary trends.

Market implications

- Lower risk-adjusted expected returns due to high valuations and decelerating growth
- 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 income and growth story intact

UPSIDE SCENARIO 15%

Inclusive and sustainable growth

Analysis

- **Pandemic recedes** more quickly than anticipated.
- Extra savings and wage rises fuel **consumption** with no erosion on corporate margins.
- **Productivity gains** thanks to tech changes and structural reforms.
- **Inclusive growth** thanks to the fight against inequality.
- **Inflation** remains under control.
- **Higher interest rates** due to stronger investment and less savings.
- **Central Banks** on the way to normalisation, well received by financial markets.
- **Debt is sustainable** thanks to strong growth and a gradual shift towards fiscal discipline.
- **Possible triggers** include good policies (e.g., structural reforms, effective vaccine campaigns, and inclusive finance thanks to decentralisation).

Market implications

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

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

TOP RISKS

Monthly update

We have amended the risks to take into account our 2022 central scenario, with no change to the probabilities.

We consider Covid-19-related risks to be part of the economic risks. Risks are clustered to ease the detection of hedging strategies, but they are obviously linked.

ECONOMIC RISK 20%

— **Pandemic 2.0**
  - Despite mass vaccinations, a new Covid wave kicks off in the Northern Atmosphere.
  - Variants with limited vaccine efficacy undermine the economic recovery (new lockdowns or mobility restrictions).

— **Supply chain disruptions** carry on, and input cost pressures lead to corporate earnings recession.

— **China property market collapses,** leading to lower growth prospects

— **Oil & Gas shock** driven by surging demand and capex cuts

— **Monetary policy mistake**
  - As inflation expectations rise, the Fed and large DM central banks tighten financing conditions too early, hurting the recovery while inflation eventually falls back
  - Central banks' miscommunication leads to greater uncertainty.

— **Climate change-related natural events** hurt growth visibility.

+ **Cash, linkers, JPY, Gold, USD, Quality vs. Growth, Defensive vs Cyclicals**

- **Oil, risky assets, AUD CAD or NZD, EM local CCY**

FINANCIAL RISK 20%

— **De-anchoring inflation expectations** lead to a bond market dislocation and harsher monetary tightening.

— **Corporate solvency risk increases,** despite improving fundamentals once central bank liquidity and government supports are withdrawn.

— **Sovereign debt crisis**
  - With public debt as a share of GDP reaching historically high levels in peacetime, most countries are vulnerable to rating downgrades and rising interest rates.
  - Emerging market weaknesses could also face a balance- of-payments crisis and increased default risks.

— **Widespread greenwashing and ESG investment bubble**

— **USD instability** and gradual loss of its reserve currency status

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

- **Oil, risky assets, frontier markets and EMs**

(GEO)POLITICAL RISK 20%

— **Accidental confrontations** in the South China Sea or the Taiwan Strait

— **US & Europe vs. China cold peace**
  - Escalation as the US takes a hard line with China;
  - Lost influence of the US post-Afghanistan exit and mistrust from NATO allies;
  - The EU could follow the US, despite their economic interests.

— **European populist vote,** in France or Italy on the back of the Covid crisis and rising energy prices. Increased EU fragmentation

— **EM political instability driven by:**
  - Chaotic virus crisis management
  - Higher food and energy prices, leading to a wave of unrest similar to the Arab Spring

— **US & China lose credibility** on the energy transition and undermine the Paris agreement.

— **Global warming** leads to an increased risk of conflicts, driven by water shortages and migratory movements.

— **Cyber-attack or data compromise,** disrupting IT systems in security, energy and health services

+ **DM Govies, Cash, Gold, USD, Volatility, Defensive**

- **Oil, credit & equity, EMBI**

Covid-19 situation update

Pierre BLANCHET, *Head of Investment Intelligence*

The new variant Omicron, which was discovered in South Africa mid-November, has 50 mutations, which, presumably, makes it more transmissible and potentially more severe. The WHO highlighted an increasing risk of reinfection, as well, compared to other variants. The low vaccination rate in South Africa, where less than 24% of the population is fully vaccinated, or Botswana (20%) partially explains how we got to this point. Since the Delta variant appeared in December 2020 in India and swept quickly to Europe, starting with the UK, and then reached the US, it has become the most prominent version of SARS CoV-2. A similar scenario is likely in the case of Omicron and therefore, the main questions are the effectiveness of vaccines, tests and current treatments.

At the time of this writing, none of these questions have a definite answer and probably will not have one until mid-December. Hence, the volatility in financial markets over the past weeks. mRNA vaccine producers have confirmed they can produce a new vaccine in a few months, but the billions of doses needed to cover the world won't be ready until the summer. Moreover, protection against the Delta variant is still the first priority. As temporary precautionary measures, travel restrictions are already being implemented, along with new mobility restrictions and social distancing across regions.

CROSS ASSET DISPATCH: Detecting markets turning points

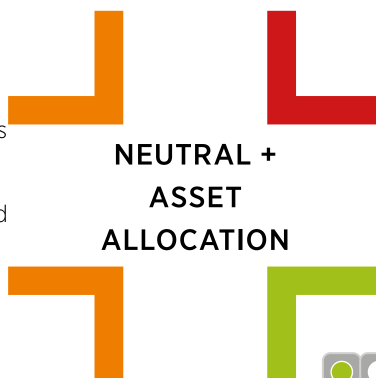
The turning point has occurred | Approaching the turning point | Not reached yet too early to call it

ECONOMIC BACKDROP

- After the strong expansion of the third quarter, economic growth rates in the Eurozone are expected to remain strong, albeit progressively moderating. High-frequency data stabilised while heading toward the pre-pandemic levels, while surveys and soft data provided evidence of an increasing impact of supply chain disruptions on manufacturing activity, and activity growth in services is softening after the strong reopening-driven rebound. The consensus continues to adjust downward in the Eurozone, while apart from Italy, economic surprises remain negative, despite some very moderate signs of a potential upward reversion.
- Economic activity in the US is accelerating in Q4 after decelerating in the second half of the Q3, in line with ongoing gradual improvements in high-frequency and soft data. The CESI Index returned to positive territory, underlain by a strong upward trend in both soft and hard data surprises. The consensus continues to trend downward, settling just below parity.

FUNDAMENTALS & VALUATION

- Multiples and several metrics flagged alerts, due to very expensive levels, even considering low rates. Liquidity has been the strongest driver of risky assets, but with CBs' smooth normalisation this support should fade somehow.
- Relative value provides some ground, although our central case is for higher rates that will provide less tailwind for risk sentiment.



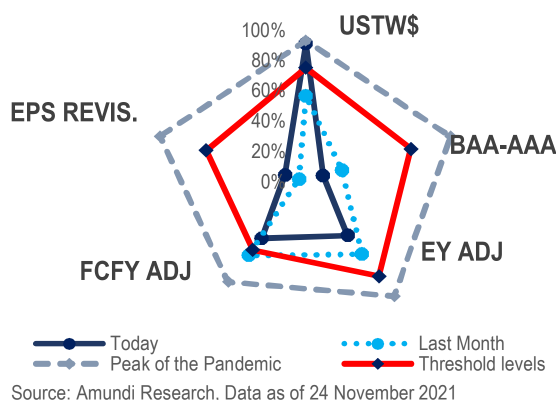
TECHNICALS

- We are still seeing the same mixed environment in technicals. Despite a solid medium-term trend in risky assets, we are lacking short-term momentum in most of those assets.
- Contrarian metrics showed that a few markets were approaching overbought levels (based on RSIs) in November, but the recent consolidation has resolved some of those dislocations.
- Technicals remain mixed, with a lack of directional bias at the time of this writing.
- This is something we find consistent with the deteriorating economic backdrop and the quite rich valuation positioning. All are pointing to higher market volatility.

SENTIMENT

- Inflation is running higher across the globe, and investors have begun anticipating a more aggressive tightening in monetary conditions despite a deceleration of global growth. Yet we find no evidence of structural deterioration in risk sentiment in the market.
- Despite the mounting wall of worries, financial conditions remain loose in most regions (GEMs are still showing early signs of tightening) and both our CAST (where the USD is the only relevant metrics running above alert) and Mood-ON Mood-OFF are struggling to turn risk-off.
- Institutional investors' behaviour seems consistent with this finding: they continue to show a marginal pro-risk attitude, especially in commodities, bonds and equities.

Cross Asset Sentinels Thresholds (CAST) still supportive



Source: Amundi Research, Data as of 24 November 2021

The CAST risk perception has failed to show a structural increase. EPS revisions have stopped deteriorating with the better-than-expected Q3 reporting season and credit risk premiums remain low and a function of still-loose financial conditions. Yet the USD is the dimension calling loudly for risk-off, and its spill-over into the residual dimensions needs to be closely monitored.

Methodology: We consider five inputs, which we call "sentinels": USTW$, Moody's Baa-Aaa, EPS revisions, Adjusted Earnings Yield Risk and Adjusted Cash Flow Yield Risk. These sentinels are used to reposition our tactical asset allocation. Once sound thresholds are detected, the five variables are aggregated as an indicator that anticipates the market's stress conditions, with a certain level of conviction. The pentagon visualises the five sentinels where the red line represents the alert threshold. The greater the distance above the red line, the higher the risk perception, and eventually the need to move closer to a defensive asset allocation.

GLOBAL RESEARCH CLIPS

1 Reassessing DM central banks policies

- The Federal Reserve has mastered its communication, guiding markets through the start of its tapering process in the smoothest way possible with no significant market volatility.
- The ECB pushed back the recent pick-up (and anticipation) in the pattern of policy rate hikes, but had to reinforce the message several times to get a meaningful effect on pricing.
- The Bank of England misguided market participants by not raising rates as expected and not giving clear guidance on the months to come, effectively triggering a material correction not only on the UK curve but on the rest of DM short term yields, as well.
- December monetary policy decisions will take into account the impact of the new Omicron variant and its consequences on the growth and inflation outlook.

Investment consequences:

- Markets are reassessing to less aggressive pricing for a lift-off in interest rates and getting closer to Amundi's view. We now expect two Fed hikes in 2022.
- Curves could flatten as growth decelerates, but we reiterate the short duration call.

2 Italy: economic backdrop, valuation and technical are all supportive

- New positive macro surprises with higher-than-expected Q3 GDP (after a very strong Q2), improved rating outlooks (S&P, DBRS), supportive technicals and attractive relative valuations support a renewed wave of optimism towards Italian debt.
- Italian equities offer a good opportunity as well, thanks to attractive valuations (PE 2022 at 11.5x, vs 14.5 for Europe), historical high consumer and business confidence, and the potential to enjoy good relative EPS growth next year and positive earnings revisions.

Investment consequences:

- Investment case reinforced for long BTPs and long BTP-Bund spreads and positive view on FTSE/MIB.

3 DM equity markets: still all about momentum and risk appetite

- A strong earnings season outweighs the fear of margin pressures, thanks to strong demand and some pricing power.
- The strength of equity markets has managed to overcome a challenging economic backdrop (stagflation, deceleration of the economic momentum and worsening economic surprises) and high valuations, thanks mainly to benign financial conditions and elevated risk appetite.

Investment consequences:

- Regional allocation driven by profitability and debt rather than valuation: we like Japan and the US over GEMs, Asia Pac ex Japan and Europe.

4 EM macro momentum: Asia mildly picking up versus Latam and CEEMEA

- While EM macro momentum is still negative, for the first time in a while we see a shift across the regions, favouring Asia vs Latam and CEE/MEA.
- Overall, softening domestic and mainly external demand will result in lower growth projections.
- We expect China's GDP growth to stay close to, but below, 5% over the next two years. EM growth should be above 6% in 2022 and 4.3% in 2023, while inflation should be above 4% on average.

5 Reiterate our positive call on the USD

- The recent USD strength has been triggered by positive macro data and historically high inflation, leading to expectations of a faster tapering process and rate hikes in 2022.
- The bearish dollar view – which assumed that too much was priced in and that the Fed is likely to disappoint – has been proven wrong in 2021 and could once again be proven wrong in 2022. We believe the greenback has not deviated from its long-term valuation level.
- While expected growth/carry are pointing to lower upside, we remain positive on the USD on a 12 month horizon.
- Our EUR/USD 2Q 2022 target is now 1.10 versus a market consensus of 1.15. Our 12-month target remains 1.14 (consensus at 1.17).

AMUNDI ASSET CLASS VIEWS

	Asset Class	View	1M change	Rationale
EQUITY PLATFORM	US	=		The ongoing earnings season highlighted that companies have been able to navigate margin pressures and supply chain bottlenecks for now. However, with inflation and supply-demand mismatches staying persistent amid high valuations and slowing growth momentum, we remain very selective and continue to focus on fundamentals. In this respect, we are monitoring the progress on the Social Infrastructure Bill that aims to boost long-term growth.
	US value	+		As the economy progresses along a slower recovery curve, we look for names that will benefit from reopening but also possess the pricing power to pass on rising costs to consumers (sustainable earnings growth), have a sticky client base and display a tendency to improve their ESG performances. Strong selection is crucial in identifying these names.
	US growth	-		In an environment of rising inflation, and potentially higher US rates, long duration stocks whose valuations are dependent more on long-term future cash flows could be negatively affected. This, coupled with the fact that valuations are already expensive in some corners of the market, makes us cautious in this area.
	Europe	=		Markets have been driven by strong earnings and progress on economic recovery (uneven), but we believe absolute valuations are stretched in some segments and therefore the scope for stock picking is high. We are positive on companies that can preserve margins and those that operate in the value, quality and cyclical spaces. Our focus is on fundamentals and ESG, as this will unearth names that can deliver returns beyond the short-term earnings season.
	Japan	=		Japan would benefit from political stability (stimulus) under the new leadership, expectations of improving earnings growth and attractive relative valuations. As Covid cases decline, the country's recovery should catch up with rest of the DM.
	Emerging markets	=		EM prospects look attractive from a long-term perspective as the region emerges from the crisis. However, we remain very selective across geographies and see the regulatory actions in China as a source of near-term weakness, even though the country presents opportunities in the long run. In addition, relative valuations in EM look attractive, as does economic growth in the medium term. With a tilt towards value and cyclicals, we like countries such as Russia and India.
FIXED INCOME PLATFORM	US govies	-		Inflation pressures persist, testing the Fed's tolerance threshold, even as the CB announced its taper plans and moves towards normalisation. The medium-term path for nominal and real rates must be monitored and we believe that the massive debt and fiscal deficit will put upwards pressure on core yields. Given that this move will not be linear, we remain cautious on duration but flexible across the curves. On TIPS, we remain constructive but are watchful of valuations.
	US IG corporate	=		We look for quality credit but prefer company-specific risk over beta exposure in IG. On the other hand, we avoid debt where increases in core yields could have negative impacts. Consumer and residential mortgage markets remain strong as delinquencies remain moderate, but we think investors should be watchful of duration extension due to increase in rates.
	US HY corporate	=		In line with our aim to balance yield and quality, we remain selective on HY and rely less on directionality even as credit fundamentals are improving. We avoid areas of excessive leverage.
	European govies	-/=		We stay defensive on core and semi-core European government debt amid inflation pressures but acknowledge that the ECB will maintain a supportive stance to maintain accommodative financial conditions despite slowing its asset buying. On the debt of peripheral countries such as Italy, however, we are positive due to the nation's strong economic growth prospects and potential benefits from Next Gen EU funds.
	Euro IG corporate	=/+		Credit fundamentals are improving and companies look to be able to withstand supply bottlenecks for now, as evidenced by recent results. However, we are monitoring volatility from core yields, dispersion of credit metrics across companies and liquidity. Thus, through a selective approach, we prefer short-dated assets, with limited directional risk, and are exploring names that display potential to improve metrics before the premium sets in (rising stars, BBBs).
	Euro HY corporate	=		We remain active in HY and believe subordinated debt offers attractive yield as we are seeing improving distress ratios and accommodative financing conditions. However, there is a need to remain selective. Investors should balance quality, yield and stay mindful of liquidity across markets in light of the approaching year-end.
	EM bonds HC	=/+		In an overall defensive stance on duration, we continue to favour HC debt and maintain a bias towards HY over IG as it offers attractive yields. However, we are very selective in light of the Fed's policy normalisation and lower vaccination rates in EM compared to DM.
	EM bonds LC	=		We see some challenges for LC debt stemming from a stronger dollar but there are opportunities from a bottom-up perspective. Countries such as Russia continue to be supported by strong commodity prices but we are monitoring idiosyncratic risks and the situation in China's real estate sector.
OTHER	Commodities			Commodities are still consolidating at current levels, digesting news on growth and potential shortages. Supply issues and bottlenecks will last for a while, supporting base metals and energy prices. However, central banks and real rates are still the key variables for gold. Finally, oil, for the time being, is being driven by OPEC decisions to increase production.
	Currencies			Stronger-than-expected US inflation, labour market and retail sales data are affecting investor expectations, indicating an earlier rate lift-off from the Fed, but we are monitoring this closely. In the short term, we maintain our preference for the USD, especially vs low-yielding currencies.

LEGEND

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Negative			Neutral	Positive			Downgrade vs previous month	Upgraded vs previous month

Source: Amundi, as of 26 November 2021, 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.

DISCLAIMER TO OUR FORECASTS

The uncertainty around the macro forecasts is very high, and it triggers frequent reassessments any time fresh high frequency data are available. Our macroeconomic forecasts at this point include a higher qualitative component, reducing the statistical accuracy and increasing the uncertainty through wider ranges around them.

METHODOLOGY

— Scenarios

The probabilities reflect the likelihood of financial regimes (central, downside and upside scenario) which are conditioned and defined by our macro-financial forecasts.

— Risks

The probabilities of risks are the outcome of an internal survey. Risks to monitor are clustered in three categories: Economic, Financial and (Geo)politics. While the three categories are interconnected, they have specific epicentres related to their three drivers. The weights (percentages) are the composition of highest impact scenarios derived by the quarterly survey run on the investment floor.

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