CENTRAL & ALTERNATIVE SCENARIOS

Monthly update

Significant progress in managing the pandemic, massive fiscal impulse in the US, and boosters in the RoW amidst accommodative monetary policies. All these call for a rebalancing of the probabilities assigned to our scenarios. We are raising the probability of our upside case from 10% to 20% and lowering the probability of our downside scenario from 15% to 10%. We have lowered the probability of our central scenario, which assumes improving growth and a contained inflation trajectory, from 75% to 70%. In this scenario, equities outperform on the back of abundant liquidity and improving fundamentals, while higher US bond yields and slow vaccine rollout in the EU pose tangible risks.

DOWNSIDE SCENARIO 10%

Stagflationary pressure

Analysis

- Genetic evolution of the virus leads to relapses in economic growth, and lockdown measures until 4Q21, prolonging the crisis
- Vaccine side-effects and/or lasting shortages undermine confidence and diminish global prospects
- The highly pro-cyclical US policy ends up destabilising inflation expectations and causes a rise in interest rates, the USD and/or commodities, which destabilises risky assets (volatility shock) and impairs financial stability. Tighter financial conditions exacerbate economic and financial fragilities
- Chinese growth slowdown spills over to DM economies
- Protectionism and de-globalisation accelerate, negatively affecting trade and global value chains

Market implications

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

CENTRAL SCENARIO 70%

Multi-speed recovery

Analysis

- Policy boosters allow a multi-speed recovery narrowing the growth premium gap between EMs and AEs
- Improving macro and micro fundamentals make financial markets resilient
- Massive vaccine rollouts in 1H21, though uneven across regions. Possible weakening in growth (until Q4 21) in some countries, due to delays in vaccination and/or new lockdowns
- Strong political commitment to mobilise fiscal policies in AEs, but timely execution in EZ is a risk
- Accommodative monetary and fiscal policies continue to support the recovery, keeping deflationary risks at bay and allowing debt/GDP ratios to stabilise
- Positive momentum in corporate earnings and reducing solvency risks
- The Covid crisis exacerbates income and wealth inequalities, thus increasing social and political tensions

Market implications

- Progressive rotation from Credit HY into equities, favouring value and cyclicals
- Contained steepening of US Treasuries yield curve spills over into EZ and EM.
- Maintain growth and income pockets with EM Equity and credit on rising earnings. Selective on EM HC.

UPSIDE SCENARIO 20%

Sustainable & inclusive recovery

Analysis

- Mass vaccinations resolve the public health crisis by the end of 1H21, eventually enabling a full global recovery in 2H21
- With less uncertainty, policy boosters feed through to the real economy and financial markets, closing the gap between manufacturing and service sectors
- Savings turn into consumption on increased disposable income, which allows a virtuous circle of growth/ inflation (no global overheating)
- Medium-term productivity gains from new digital and green developments
- Inclusive and sustainable growth diminishes the need for further policy support to reduce inequality gaps

Market implications

- US Treasuries curves bear steepen on fast rising growth and inflation expectations
- Favour risky assets with cyclical and value exposure
- Favour linkers as an inflation hedge

TOP RISKS

Monthly update

Risks are clustered to ease the detection of hedging strategies, but they are obviously linked. We have amended the overall narrative and change the probabilities of risks in light of recent developments and changes in our central & alternative scenarios.

ECONOMIC RISK 15%

- **Pandemic 2.0 with vaccine rollout issues**
  - Unexpected logistic issues or side-effects of the vaccine could have a very negative impact on investor and business sentiment
  - One or several virus variants that would make existing vaccines ineffective would undermine the economic recovery
- **A protracted recovery with multiple relapses** might hit business and consumer confidence, looping in sectors that have not yet been directly hit by the pandemic, such as financials
- **Underestimated hysteresis effects in the labour market,** with rising unemployment and uneven impact, could undermine the recovery and generate social tensions
- **A rebirth of inflation and a second "taper tantrum"**
  - Upward inflation pressures could build up, as the epidemic fades away
  - QE programmes may become problematic as inflation expectations rise
  - Inflation dynamics and central banks' reaction function could be sources of uncertainty, in particular in EM, where inflation is close to CBs' target
  - An early exit or miscommunication by the Federal Reserve could lead to a second taper tantrum similar to 2013

+ **Cash, linkers, JPY, Gold, USD, Defensives vs. Cyclicals**

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

FINANCIAL RISK 20%

- **De-anchoring inflation expectations** leading to a bond market dislocation as an outcome of policy mistakes such as pre-emptive monetary policy tightening or outsized fiscal plans
- **Corporate solvency risk:** Despite improving fundamentals, the magnitude of the recession increased solvency risks once central bank liquidity and government guarantee schemes 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, in the event of policy errors
  - Emerging market fragilities (single-commodity exporters, tourism) could also face a balance of payments crisis and increased default risks
- **USD instability, which could impact in both directions:**
  - **(1) depreciation c**ould push the Fed to stop its APP and negatively impact the Treasuries market, bring deflation into the EZ and Japan, and undermine the EM recovery; **(2) appreciation** could hurt EM countries, with higher UST yields spilling over into the Eurozone bond market

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

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

(GEO)POLITICAL RISK 15%

- **US/China cold war**
  - Democrats maintain uncertainties regarding the relationship with China
  - Several sanctions and delisting of Chinese companies are signs of escalation
  - Possible accidental confrontations in the South China Sea or the Taiwan Strait, where Chinese aircraft are regularly making incursions
- **Instability within, and among, EM countries** on the back of chaotic virus crisis management and rising food prices
- **Post-Brexit risk of undermined European cohesion**
  - 2020 ended with an exit deal but implementation proves to be a lot more disruptive than expected
  - The City might lose market share faster than expected
  - The UK has to decide where to stand between the US and the EU, as well as China
  - UK exploiting the divergence and looking for competitive behaviour across the EU, which would potentially undermine EU cohesion

+ **DM Govies, cash, gold, linkers, USD, volatility, quality**

- **Oil, risky assets, EMBI**

CROSS ASSET DISPATCH: Detecting markets turning points

How to the read turning point assessment

Not reached yet too early to call it | Approaching to the turnaround | Turnaround happened

ECONOMIC BACKDROP

- Economic activity in the Eurozone remains heavily impacted by the Covid-19 restrictions, as confirmed by both soft and high-frequency data. Divergences at both national and sector level remain evident, with the manufacturing sector outperforming services. Growth should progressively gain momentum from Q2 onwards as economies gradually reopen.
- Economic activity in the US is gradually gaining momentum with both high-frequency and soft data showing a sustained increase in private-sector business activity in the manufacturing and service sectors. The new fiscal stimulus will further support growth.
- A gradual reversal in economic surprises will likely continue as further upside surprises become increasingly difficult to materialise, as the consensus remains very high.

FUNDAMENTALS & VALUATION

- Current market levels already discount a significant part of the expected recovery in profits.
- Absolute PE levels are above historical trends despite growth remaining a solid argument for a temporary divergence from the historical average.
- After the recent spike in rates, the relative value metrics offer less support for markets to move significantly higher.

DEFENSIVE ASSET ALLOCATION

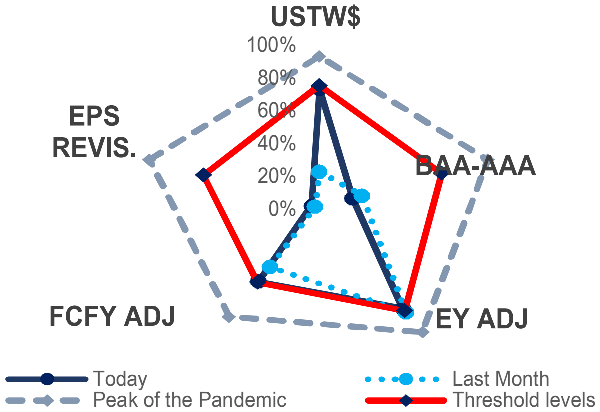
TECHNICALS

- Technicals remain mixed and challenging for the entire risky assets spectrum.
- While equities and HY still show a decent momentum score (signalling that investor appetite is still anchored to those assets), contrarian signals are flashing orange (i.e. neutral exposure).
- Our RSI-based signal looks less stretched now that markets are in a consolidation phase, yet we remain far from a green light.
- With rising interest rates weighing on multiples (which remain stretched and linked to the huge liquidity injected into the system) and no clear-cut directionality in many risky markets, we see technicals as neutral at present.

SENTIMENT

- Despite the recent turbulence, our risk sentiment metrics remain strong in all components
- The overall RISK OFF probability remains low and continues to suggest an overweight in risky assets.
- The repricing in nominal and real rates has been sharp and strong, yet our financial condition indices are firmly in easing territory across all of the main regions.
- The point of attention relates to the USD trend (if more pronounced and broad-based it would add pressure to our CAST) and the already visible consolidation in earnings revisions.
- The latter seems rational given the strong bounce back we had in H2 last year. It is something the market can possibly look through in the event of strong EPS results. While the peak in euphoria may be behind us, it is important to check closely whether a sharp mood inversion could occur.

Cross Asset Sentinels Thresholds (CAST) still supportive



Source: Amundi Research, Data as of 18 March 2021

CAST flags extremely low risk perception.

Sentinels remain in pro-risk territory due to a general improvement in all its components (except ERP adjusted for credit risk).

Methodology We consider five inputs which we call “Sentinels”: USTW$, Moody’s Baa-Aaa, EPS revisions, Earning Yield risk adjusted and Cash Flow yield risk adjusted. 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 visualizes 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 Growth narrative taking the lead corroborates the "risk-on" stance across assets

- In the US, significant progress in pandemic management, massive fiscal impulse and huge household savings are underpinning the growth dynamic and should lead to a DM economic recovery.
- We have revised our UST 10y 12-month yield range forecast to 1.8%-2% (from 1.5-1.8%).
- The Eurozone is lagging behind, as lockdown measures limit the recovery, and we expect a decoupling of US vs. Eurozone economic growth. The ECB will therefore maintain easy financial conditions.
- The rebound in Eurozone corporate earnings growth is not fully priced in by the markets, while interest rate expectations are unlikely to move higher. The value/cyclical features of EU equity markets confirms our preference for European equities.
- We expect the economic growth premium between EM and DM to narrow, suggesting a more cautious and country specific exposure to EM equities

2 Rates moving towards a higher regime as growth outlook materially improves: volatility and speed are a key risk, with global spillovers via tightening financial conditions

- The expected ranges call for a contained steepening in the UST 10-30 year section.
- As the long-end of the yield curve is already a source of risk for institutional investors' P&L, we believe that the Fed will be vigilant and prevent a strong rise in UST 30y yields and avoid the negative snowballing effects across asset classes.
- The rise in 10y real yields will be nevertheless be limited by the FAIT (Federal Reserve Average Inflation Targeting) framework, which anchors 5Y real rates, as the Fed commits to raise rates only when Core PCE is sustainably above 2%
- The reaction of EM Fixed Income and FX to higher UST yields has been heterogeneous and smoothed by the broader "risk-on" environment
- The rebound in the US dollar and US interest rates are not yet sufficient to alter our broad preference for EM vs. DM.

3 USD: Short-term bull, medium-term dull

- The USD appreciated vs low-yielding FX, while commodity currencies are still outperforming the greenback.
- As US inflation expectations start to drift lower while real rates are holding up, we expect a strengthening of the USD trend vs the entire G10 spectrum.
- We have revised our EUR-USD targets accordingly: short-term to stay in the current (1.16 to 1.18), and returning to its depreciation trend in the medium term (towards 1.24)

4 Turkey: unexpected change at the CBRT

- After a few months of orthodox MP (+875bps of tightening since November 2020), the governor of the Central Bank of the Republic of Turkey (CBRT) was sacked the same week he raised the policy rates by 200bps to 19%.
- That decision has triggered some turmoil on the Turkish assets and a sudden repricing of MP expectations for the months to come. CBRT is now expected to cut its policy rates earlier and by more than expected. While inflation should moderate by the end of 2021, in the next months it is expected to climb up to 18% YoY.
- The market has considered the event an idiosyncratic incident with only a brief impact on EM asset classes.

Covid-19 situation update

by Pierre BLANCHET, *Head of Investment Intelligence*

Fifteen months after the virus left China, the WHO has registered 128 million confirmed cases and 2.8 million deaths. Nearly 80% of registered contaminations are in Europe and the Americas. Despite being the most populated continent, Asia has not recorded more than 15 million cases overall. Since there is still no treatment, mass vaccination to reach herd immunity and social restrictions are the only solutions available. A total of 520 million vaccine doses have been administered so far, with 140 million doses in the US alone.
The number of available vaccines is rising. Europe granted approval for the J&J vaccine in March. Novavax (US) and CureVac (Germany mRNA vaccine candidate) are in late-stage trials and may be approved in the coming weeks. Pharma companies distributing available vaccine are now working on boosters, next-gen vaccines and paediatric trials. The AstraZeneca/Oxford vaccine, mainly used in Europe, has been paused several times and its efficacy has been revised downward.
An effective therapy has yet to be found. GSK & Vir are trialling an antibody therapy, which is showing an 85% decline in hospitalisation or death vs a placebo.

Coronavirus Vaccine Tracker

PHASE 1	PHASE 2	PHASE 3	AUTHORIZED	APPROVED	ABANDONED
47	33	23	6	7	4
Vaccines testing safety and dosage	Vaccines in expanded safety trials	Vaccines in large-scale efficacy tests	Vaccines in early or limited use	Vaccines approved for full use	Vaccines abandoned after trials

AMUNDI ASSET CLASS VIEWS

Platform	Asset Class	View	1M change	Rationale
EQUITY PLATFORM	**US**	=		Expectations of pent-up consumer demand in H2, driven by massive fiscal stimulus and infrastructure spending, the earnings recovery and a supportive Fed paint an optimistic picture for an economic recovery and equities. The rotation towards quality cyclicals and value stocks should benefit from this environment. However, expensive valuations in some corners of the market and potential tax hikes are areas to be monitored. Overall, the need to be selective is high.
EQUITY PLATFORM	**US value**	+		Economic reopening (reflation) and a return to normalcy, coupled with an accommodative Fed, are the factors that allow us to be constructive on value. Long term, it offers a combination of structural growth, quality, stability and ESG improvers.
EQUITY PLATFORM	**US growth**	-		We are cautious on growth amid concerns over high valuations, which have been boosted by low interest rates in past years. However, when rates start to rise, the discounted value of future earnings may be negatively affected.
EQUITY PLATFORM	**Europe**	=		Even though vaccinations in Europe are progressing at a slow pace and the recovery will be slow, the current earnings season has been positive so far. The cyclical and value features of EU markets should help overcome the economic growth lag. However, we remain focused on stock selection and fundamental analysis and are exploring opportunities in segments linked to the recovery.
EQUITY PLATFORM	**Japan**	+		Our positive stance on Japan is corroborated by the strong earnings season, which has supported the performance of Japanese equities in 2021, coupled with the weakening of the yen. The country's cyclical and industrials tilt will continue to benefit from a global cyclical recovery.
EQUITY PLATFORM	**Emerging markets**	++		Despite some increase in US rates, we believe the potential for EM growth, particularly EM Asia, remains intact. The rebound in global growth and the planned rebalancing of a more sustainable growth path in China is positive overall for EM. However, we remain very selective in identifying themes linked with domestic consumption, the countries most affected by Covid-19 crisis (now in recovery mode) and names with value/ cyclicals characteristics.
FIXED INCOME PLATFORM	**US govies**	-/=		We remain defensive on US duration in light of the massive fiscal stimulus, deficit and inflation concerns. While we acknowledge that the Fed's recent remarks caused yields to rise amid the improving prospects of the economy, the CB is still striving to maintain accommodative financial conditions. Therefore, investors must stay vigilant. On Treasury Inflation-Protected Securities, we are positive. In our US portfolios, inflation and curve steepening remain reasons for us to be cautious on USTs.
FIXED INCOME PLATFORM	**US IG corporate**	=		We recommend investors limit duration to reduce the interest rate risks of their portfolios and they should also monitor the effect of rising UST yields. However, investors can identify attractive idiosyncratic stories by staying selective and focusing on shorter duration debt. Securitised credit is attractive in light of the strong consumer, but there is scope for some volatility and investors should be mindful of valuations.
FIXED INCOME PLATFORM	**US HY corporate**	=		While we acknowledge that HY offers attractive carry, investors must maintain a balance between quality, yield and liquidity. This is important as CCC-rated debt continues to lead the default rates in US HY, although an economic recovery should improve credit metrics.
FIXED INCOME PLATFORM	**European govies**	-/=		We are defensive on core-Euro bonds even though we acknowledge the divergence between US and EU economic growth and ECB support should prevent EZ yields from rising too much. On peripheral debt, we are positive, mainly on Italy, due to political stability, but believe there are opportunities across the Italian yield curve.
FIXED INCOME PLATFORM	**Euro IG corporate**	=/+		The ECB's recent reassurance that asset buying under the PEPP umbrella will be conducted at a "significantly higher pace" indicates strong support, given that rising yields in the US were impacting the markets. On the other hand, low rates amid easy financial conditions mean investors' search for income will continue, mainly in short maturity instruments and in subordinated BBB-rated categories.
FIXED INCOME PLATFORM	**Euro HY corporate**	=		The improving economy and the support from the central bank should mean the default situation is benign. However, this is not the time to put your guard down, and we believe investors should remain very selective to distinguish high quality credit from low quality and balance the need to stay liquid and earn higher yield.
FIXED INCOME PLATFORM	**EM bonds HC**	=/+		In the short run, HC debt could face some headwinds from rising US rates. We are more cautious on HY and believe spreads have outperformed the market already. Therefore, investors should await better entry points at more attractive levels. Long term, EM HC could still support investors' search for yield.
FIXED INCOME PLATFORM	**EM bonds LC**	=	▼	LC debt looks vulnerable due to a strengthening dollar and accordingly we are very selective. With rising rates in the US, EM policymakers may come under pressure to hike rates or tighten policy. The bullish cycle in local FX is now behind us.
OTHER	**Commodities**			Cyclical commodities should be supported by economic recovery expectations and reflationary trades. Oil prices are expected to stay at current levels in the coming months, although the ongoing overshooting could persist in Q2. In metals, gold may suffer less from higher rates, as the Fed has confirmed its dovish and low-rates tone for now.
OTHER	**Currencies**			Huge liquidity injections in US and the country's deteriorating fiscal situation remain major headwinds for the USD over the medium term. However, expectations of a strong US growth differential over RoW should support the greenback in 2021.

LEGEND

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Negative			Neutral	Positive			Downgrade vs previous month	Upgraded vs previous month

Source: Amundi 22 March 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.

Amundi ASSET MANAGEMENT | Research

CROSS ASSET
INVESTMENT STRATEGY

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