CENTRAL & ALTERNATIVE SCENARIOS (12 TO 18 MONTHS HORIZON)

Monthly update

We revise the probabilities of our alternative scenarios. Some of the risk factors we identify may occur in our central scenario, which is probably not yet fully priced in, especially by equity markets. **We think risks remain skewed to the downside in the short term, but at the same time, we believe that it would take an unlikely combination of several risk factors to trigger the downside scenario at the 12-18 month horizon.** At this horizon, we believe that the upside scenario of rapidly falling inflation is now more likely to materialise. Indeed several factors of different nature can push prices down: easing gas prices, combined tightening of global monetary policies (which has a delayed impact), and normalisation of global value chains thanks to China's re-opening.

DOWNSIDE SCENARIO 10%

Recession in DM

Analysis

- Worsening/expanding **war in Ukraine.**
- Worsening energy crisis and **deep recession in Europe, coupled with a US recession.**
- **Covid-19 resurgence.**
- **De-anchoring of inflation expectations.**
- **Governments can no longer implement countercyclical fiscal policies.**
- **Climate transition measures postponed.**

Market implications

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

CENTRAL SCENARIO 70%

Stagflationary episode, with rising divergences and persistence

Analysis

- **Stalemate in the Ukraine war.** We expect a ceasefire at some point in late 2023; in the meantime, the situation is likely to deteriorate further.
- **Energy crisis is here to stay.** Gas prices expected to rise in the restocking phase.
- **Covid-19** is an endemic disease.
- **Sticky core inflation due to unit labour costs.** Inflation fails to return to CB target by 2024.
- **Global economic slowdown in 2023,** but with growing divergences: anaemic growth in Europe, rising recession risks in the United States, rebound in China with the reopening. Sub-par growth expected in 2024 in most DM.
- Global **nominal GDP to trend higher,** mitigating the impact on earnings.
- **CB divergences:** Fed and ECB to stop hiking rates by mid-2023; PBoC on an easing bias.
- **In Europe, fiscal policies** have not been well coordinated and targeted, but Europeans are making progress on consultation to respond to the US IRA. The US fiscal impulse is expected to be neutral for 2023-24.
- **Climate change** adds to stagflationary trends.
- **Climate risk** hampers growth

Market implications

- Lower risk-adjusted real returns expected.
- Contained steepening of yield curve, govies regain their function of hedging against a deeper recession.
- Inflation hedge via gold, linkers, equities, real assets, and commodities.
- EM: short-term caution, long-term real income, and growth story intact.

UPSIDE SCENARIO 20%

Inflation falls back

Analysis

- **Ceasefire in Ukraine in sight.**
- **Russia resumes partially gas exports to Europe,** commodity market normalises.
- **Inflation and core inflation fall back quickly.**
- **Recession fears** dissipate and inflation returns to more normal levels, easing pressure on CB.
- **No V-shaped recovery,** but reduced uncertainty and increased confidence may yet fuel domestic demand in DM.
- **Climate change** policies and energy transitions top priority.

Market implications

- US Treasury curve to bear steepen.
- Favour risky assets with cyclical and value exposure.
- USD depreciation.
- Selective increase in the exposure to EM debt in LC.

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

TOP RISKS

Monthly update

We see risks on all fronts, but with a little less intensity at the beginning of the year. As such, we lowered the probabilities of the economic and financial risks from 25% to 20%. Economic fundamentals have deteriorated globally, which is reflected in the central scenario, but is not yet fully priced in the equity market. The course of the Ukraine war and its potential implications can tip the scenario in either direction: risks are tilted to the downside in the short term, but the probability of ceasefire by year-end remains significant. We consider Covid-19-related risks as part of the economic risks. Risks are clustered to ease the detection of hedging strategies, but they are related.

ECONOMIC RISK 20%

- **Global recession** driven by an oil/gas shock, tightening monetary conditions, and a loss of purchasing power.
- **Severe energy crisis in Europe,** leading to a **deep recession** (confidence shock).
- **Economic crisis in Eastern Europe** following a collapse of the Russian economy, elevated energy prices, uncontrolled inflation, and migrant crisis.
- **Central banks continue to raise interest rates**, giving priority to the fight against inflation.
- **Global profit recession** triggered by the global slowdown, coupled with persistent input-cost pressures.
- **End of the great coincidence:** with stagflationary pressure, CB and governments' goals are no longer fully aligned: the room for countercyclical fiscal policies is reduced.
- **Europe: inconsistency in the policy mix (accommodative fiscal stance coupled with restrictive monetary policy)**
- **Pandemic:**
  - Risk of a more dangerous and vaccine-resistant variant.
  - New lockdowns or mobility restrictions.
- **Climate change-related natural events** hurt growth visibility and social balance.

FINANCIAL RISK 20%

- **US debt ceiling**
  - Republicans and Democrats fail to reach a compromise: the risk of a US default causes severe financial turbulence and possibly a serious financial crisis
- **Sovereign debt crisis:**
  - An extended war in Ukraine would hurt DM vulnerable public finances with public debt ratios already at historic highs.
  - De-anchoring inflation expectations could lead to harsher monetary tightening and to a bond market dislocation.
  - Most countries are vulnerable to rating downgrades and rising interest rates.
  - Weak EM could face a balance-of-payment crisis and increased default risks.
- **Corporate solvency risk increases,** amid deteriorating fundamentals, rising uncertainty, and corporate margins under pressure (high input cost, double orders lead to profit warnings).
- **Widespread greenwashing and ESG investment bubble undermine the energy transition funding.**

(GEO)POLITICAL RISK 25%

- **Ukraine war:**
  - **Risks are titled to the downside.** There is a **60% likelihood** of a negative development of the war, including a **25% likelihood of direct confrontation with the West.** This risk grows the more Russia faces military defeats.
  - Despite our expectation for the conflict to worsen in the meantime, **our base case is an end to hostilities 2023** (most likely H2) at **35%** likelihood.
- Following mid-term election, **the United States will focus on domestic political battles, which will heighten tensions with China,** as Republicans and Democrats compete for hawkishness, **contributing to growing the 'Taiwan' risk in 2023.**
- **EM political instability is driven** by higher food and energy prices, leading to a wave of social unrest.
- Iran or Korea **nuclear programmes** renewed concerns and sanctions.
- **Cyber-attack or data compromise,** disrupting IT systems in security, energy, and health services is elevated, as Russia seeks to undermine Western support to Ukraine.

	Economic risk	Financial risk	(Geo)political risk
+	**Cash, linkers, JPY, Gold, USD, Quality vs. Growth, Defensive vs. Cyclicals.**	**CHF, JPY, Gold, CDS, optionality, Min Vol.**	**DM Govies, Cash, Gold, USD, Volatility, Defensive, Oil.**
-	**Risky assets, AUD CAD and NZD, EM local CCY.**	**Oil, risky assets, frontier markets and EMs.**	**Credit and equity, EMBI.**

CROSS ASSET DISPATCH: detecting markets turning points

Monthly update: The traffic light on technicals has turned from red to green and from red to orange on sentiment.

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

ECONOMIC BACKDROP

- Economic momentum is slowing globally amid persistently high inflationary pressures. Recession risks remain significant for H2 2023 in the United States, while for Europe the outlook has improved somewhat, although we keep expecting sluggish/contracting GDP growth in winter and below-potential growth in H2.
- Headline inflation is likely to have peaked in the United States and Eurozone. However, this is not yet clear for core inflation, particularly in Europe. Overall, we expect underlying inflation in both the US and Europe to show a higher degree of stickiness than headline, which has started to correct visibly lower, as base effects contribute to dragging down energy inflation. This underlying stickiness will be an important driver of monetary policy choices.
- The prolonged stress on the geopolitical front and the tug-of-war between fiscal support and monetary policy tightening make the final economic outcome uncertain, exacerbating data volatility.

FUNDAMENTALS & VALUATION

- Stocks look less expensive after their recent pullback, but we do not see any strong catalysts for entry points in the next few weeks.
- Stock multiples look more aligned with the current inflationary environment and tight monetary policy, but are not pricing in fully the expected profit recession. In relative terms, considering high rates, fundamentals do not favour risky assets.
- Fundamentals deteriorated further; a profit recession is the central case for H1 2023, as well.

NEUTRAL + ASSET ALLOCATION

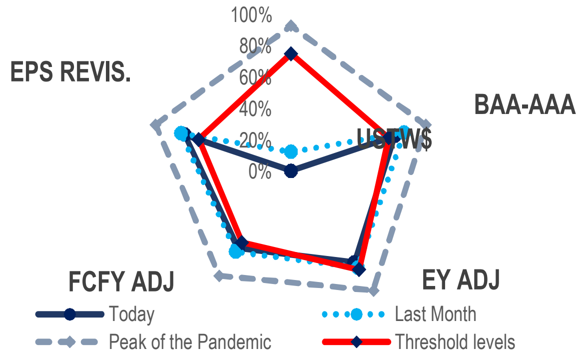
TECHNICALS

- Technicals remain mixed in January 2023. Most assets rallied strongly in early 2023, with very few exceptions. Trend-following metrics keep showing positive asymmetry for all assets, with a preference for duration products (credit and government bonds) over equity. On the other hand, most contrarian metrics show market complacency. RSIs are back to the upper bounds of their range (signalling that markets are becoming overbought across the spectrum) and positioning reinforces the message (there was no capitulation in positioning in 2022 and equity was added to the first month of 2022).

SENTIMENT

- The three consecutive downside surprises on inflation have induced a sharp reset in rates volatility since Q4 2022, resulting in easier financial conditions and improving risk sentiment metrics. Sentiment has improved strongly since last year and the dollar has been one of the main drivers lately (our CAST OFF probability fell sharply in response to that, although EPS revisions and credit risk premium remain above alert). On the other hand, financial conditions eased but are staying historically tight. Market risk concentration is growing and suggests being cautious in chasing the market (most assets rebound in tandem, while systemic risk is rising). That leaves our sentiment pillar in neutral-positive zone in January 2023.

Cross Asset Sentinels Thresholds (CAST) – The sell-off in the USD has been the strong supportive factor since November 2022, in turn translating into low CAST OFF probability. The message is confirmed in January 2023.



Source: Amundi Institute. Data as of 24 January 2023.

CAST risk perception improved strongly since November 2022, as the sell-off in the USTWD has more the offset the negative contribution coming from the other sentinels. EPS revision and credit risk-premium have been improving since Q4 2022, but remain above alert.

Methodology: We consider five input variables, called 'sentinels': US trade-weighted dollar, Moody's Baa-Aaa spread, 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 any market 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 greater the risk perception, and eventually the need to move closer to a defensive asset allocation.

AMUNDI INSTITUTE CLIPS

1 What if inflation drops much faster than expected?

- We foresee different outcomes, depending on the cause of such a drop.
- A drop of 2% faster than our current projection for 2023 – both in the United States and in the Eurozone – could result in a risky-asset-friendlier scenario if core inflation falls at the same pace and if such a positive surprise on price pressures is not the result of lower-than-expected growth.

Investment consequences

- Cross asset positioning remains defensive, with UW on equities and OW on HY.
- We have downgraded government bonds, but they remain in OW territory.
- IG moved to neutral.

2 What if the ECB terminal rate is 4%?

- A higher ECB terminal rate will entail higher costs on the growth front with few benefits on the inflation side.
- If inflation proves stronger than expected in the first half of 2023, the ECB will be more hawkish than currently expected and may push rates up to 4%.
- This should cause a prolonged contraction in the second half of the year and, overall, much weaker growth in 2024, due to monetary tightening and the cost-of-living issue, while core inflation should remain sticky overall.

Investment consequences

- EUR should prove stronger than expected against USD.

3 QT and supply fallout on euro government rates

- This year net euro issuance is set to rise sharply: net EMU-10 issuance should jump to €420bn, EU issuance to €150bn, and core and semi-core issuance to €300bn from €226bn.
- This means that a total of €720bn will have to be absorbed by markets this year, with supply coming from both core and semi-core countries, while peripheral supply is expected to fall from €140bn to €120bn overall.

Investment consequences

- Short positioning on euro duration.
- Cautious stance on peripheral spreads.

4 Budget trends across the Eurozone

- The rise in borrowing rates is not an immediate threat to public debt sustainability.
- Eurozone government debts are staying on a sound path in the near term, thanks to the still favourable interest rate-GDP growth differential.
- However, in the long term, a return to fiscal discipline is needed to ensure debt sustainability. In this respect, 2024-25 budgets will be key.

Investment consequences

- Stay short on euro duration.
- Cautious stance on peripheral spreads.

5 Earnings season early takeaways

- First US results have been positive so far, beating expectations by some 5%.
- S&P 500 EPS for Q4 2022 is forecasted to be the first negative quarter since Q3 2020, with a -1.6% drop, resulting in end-2022 earnings at +4.5%; materials and communications services should be the worst sectors.
- Stoxx 600 Q4 EPS is expected at +14.5%; FY2022 at +19.9%.
- Overall, 2023 is setting the lowest bar ever for S&P 500 EPS growth expectations (+3.2%); in Europe, expectations are close to zero (0.6%).

Investment consequences

- US equities downgraded to UW from neutral against rest of the world, mostly on the growth-value argument.

6 Outlook for primary credit markets

- We foresee limited fallout on primary credit markets from rate hikes, as low refinancing needs and heavy use of cash holdings have mitigated the fallout of monetary tightening thus far.
- However, higher funding costs and slowing growth should start hitting low-rated high-yield issuers the most in 2023.

Investment consequences

- Long credit: we keep our preference for Europe over the United States and for IG over HY.

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CROSS ASSET
INVESTMENT STRATEGY

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