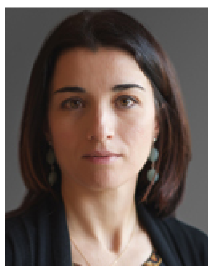
THIS MONTH'S TOPIC

2021 Recovery to continue and beat potential

- **Goldilocks continues to allow a tempered risk on positioning. Longer term, growth will likely revert to potential amid a normalised inflation rate (at least in the US).**
- **This environment provides a constructive view on risky assets, while in relative terms credit might be under pressure only later on if inflation stabilises above 3%. Not our central scenario, but still worth hedging via inflation linkers.**

Monica DEFEND,
Global Head of Research

Silvia DI SILVIO,
Macro Strategist



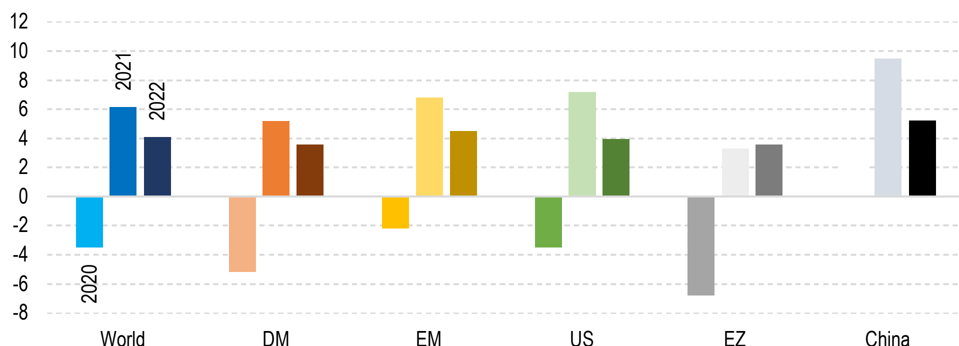
Annalisa USARDI,
Senior Macro Strategist Cross Asset Research

We confirm the financial "recovery regime" as a central scenario (with a 70% probability) for the next 12 to 18 months, with growth and macro determinants remaining paramount. This scenario assumes that the global fiscal boost and CB monetary support will be enough to achieve above-trend growth in the next 18 months, providing more support to multi-year expansionary economic development.

According to our estimates, corporate earnings will prove resilient and rebound throughout 2021 and 2022 as economic activity resumes. Under this scenario, rates should move gradually higher, although markets should be complacent enough to digest the repricing of multiples. Central banks will be crucial in keeping long-term inflation and rates expectations reasonably low. Extensive vaccine campaigns and, more importantly, **the rebound in inflation should not be a game changer for CBs' monetary policies**, and liquidity injections should remain solid, underpinning asset reflation and preserving positive financing and financial conditions in 2021.

Policy accelerators are supporting risk assets, but recent market complacency is pricing in an extreme goldilocks scenario, and pricing for perfection in expectations increases downside risks. This is reflected in the probability we assign to the downside scenario (10%), which includes a potential market correction of more than 10% i.e., in line with the historical average.

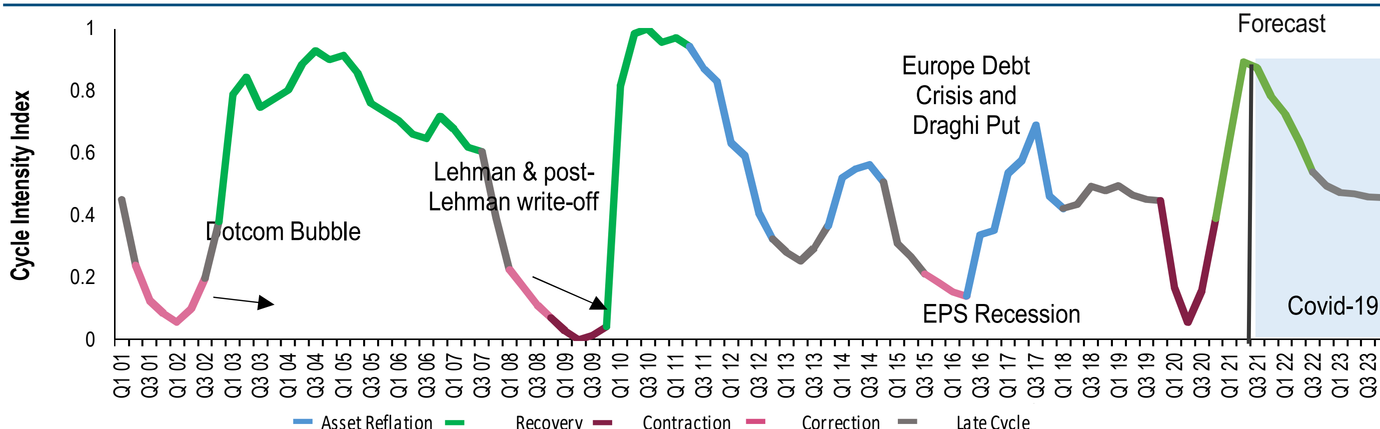
1/ Amundi Global Forecast a multi speed recovery



mid-point forecasts of average annual real GDP growth
lighter color: 2020; medium color 2021; darker color 2022

Source: Amundi Research, Data as of 19 April 2021

2/ Investment Phazer Dynamic - Smoothed



Source: Amundi Research - Data as of 31/03/2021

THIS MONTH'S TOPIC

We are convinced that inflation next year will trend higher and episodically spike mainly on base effects

1. Upgrading our 2021 global growth and inflation forecasts

From a growth perspective, we have revised our global outlook for 2021 slightly higher (global GDP from 5% to 6% 2021E, due to US upward revision in March). While the growth premium is still in favour of EMs, it has been declining marginally as the sharp resurgence in the pandemic across EMs affects mobility, even without triggering significantly broader restrictions. **Moving forward, the growth premium is expected to rebalance more in favour of DMs, due to the positive economic momentum expected in the US on the back of the new fiscal package and the prosecution of the massive vaccination campaign.** The recovery will remain multispeed, uneven and heterogeneous. While still dominated by base effects, the upward revision to the US outlook in particular is driving the improvement in developed markets, while the Eurozone is still in a tug-of-war between new waves of the virus and vaccination campaigns. **EM 2021 GDP forecasts have remained stable.** China's recovery likely continue at a solid pace, with full-year growth of 9-10%. The growth premium vs. the US will narrow.

The fiscal lever continues to play a pivotal role in supporting the recovery, especially among advanced economies, in a context of already supportive monetary policy. In the US, the approval of an unexpectedly massive $1.9 trillion fiscal package has lifted growth prospects significantly higher for 2021 and early 2022. Moreover, as we write, the recently unveiled American Job Plan (first of a likely two-tranche "Build Back Better" 10-year infrastructure plan) is beginning its legislative process through the US Congress, with the potential of providing a further boost to domestic demand and growth beginning next year. In the Eurozone, a new wave of Covid-19 spreading through countries will force governments to extend fiscal support to sectors affected by new lockdowns, with additional fiscal relaxation until the recovery is more firmly in place. The **Eurozone recovery will be deferred, not derailed, by the vulnerabilities and delays of the vaccination campaign.** On the one hand, Q4 GDP data have proven some degree of resilience and flexibility of Eurozone economies in adjusting to the "Covid-19 environment". On the other hand, the extension of lockdown measures into Q1 and part of Q2 will inevitably weigh on activity in the first half of the year. Yet, the vaccine rollout is progressing and, barring any adverse developments on the virus-variants side, a more solid rebound should take place from summer onwards. From 2022, then, the Next Generation EU plan is expected to extend growth momentum, supporting growth above potential for several quarters and particularly in key vulnerable countries, thus providing a virtuous circle supporting the whole Eurozone. Among **emerging markets, the policy mix looks more heterogeneous, and March saw the first decisive change in the policy mix and related market expectations since the beginning of the crisis.** Early hikers moved because they had cut too low and needed to start removing the extraordinary accommodation now that the extraordinary times are in the rear-view mirror and inflation is printing uncomfortably higher than expected. Other central banks favoured considerations of financial stability or very prudent and forward-thinking monetary policy management while facing FX weakness that is further complicating their risk story. Overall, we remain on the dovish side vs. market expectations, which, in some cases, are particularly hawkish. In Asia, the monetary policy tightening cycle should be the story of early 2022, due to still benign inflation dynamics and resilient external positions.

With growth recovering faster, **the annual inflation outlook has been revised higher for DMs, on a combination of higher commodity and energy prices, cost pressures and, in a few countries, stronger domestic demand prospects.** Much of the expected rise and overshoot of headline inflation this year will be linked to transitory factors, which will begin to fade in 2022, leaving core inflation dynamics to set the trend. In this respect, while we expect core inflation rates to land in slightly higher than pre-pandemic ranges in 2022, the stabilisation in the medium term at or above the central bank target seems like a US-only story. In fact, as core inflation dynamics are being prominently driven by domestic drivers, **the US economy will experience significantly lower labour slack and spare capacity compared to the Eurozone, where convergence to pre-pandemic levels will be reached much later than in the US**.

Among emerging markets, inflation is picking up, while the 2021 picture remains still benign and mostly anchored to the CBs targets on average. Although the acceleration has proven stronger than anticipated, moderating dynamics are expected after the peak (between Q2 and Q3 2021). **The main inflation drivers have been food and oil and commodity prices, all magnified by significant currency weakness since early 2021.** Countries to watch for any persistence in inflation dynamics: Brazil, Mexico, the Philippines, Russia and India (Core). Turkey is still an idiosyncratic story.

In conclusion, **while the recovery is progressing more confidently where the virus remains under firmer control (faster vaccination campaign and contained spread), several countries are currently**

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experiencing a new wave of infections and selective lockdowns, thus confirming that the global economic recovery is increasingly uneven and heterogeneous. Nonetheless, the end of the tunnel is approaching, making global growth prospects from the second half of the year more confidently on a positive tone.

Inflation: the elephant in the room

In 2021, inflation and inflationary expectations are likely to be in the spotlight.

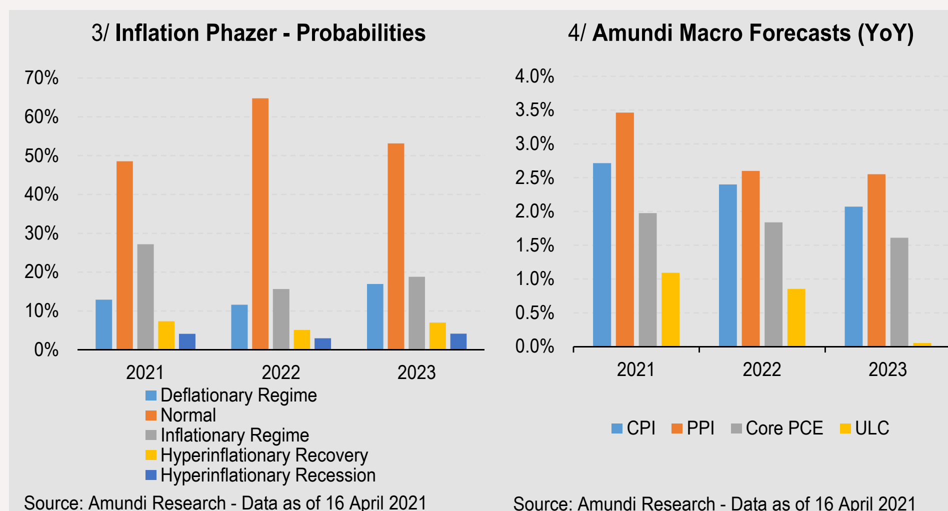
Inflation Phazer

The Inflation Phazer is Amundi's proprietary tool aiming to identify five inflation regimes, looking back at pricing data since 1960. The analysis is developed by looking at the historical evolution of the most relevant inflation indices in the US economy: Consumer Price Index (CPI), Producer Price Index (PPI), Core Personal Consumption Expenditure (Core PCE), and Unit Labour Costs (ULC) (see table below).

Table 1: Inflation Regimes

	Deflationary regime	Normal	Inflationary regime	Hyperinflationary recovery	Hyperinflationary recession
CPI YoY (%)	<2	2-3	3-6	6-10	>10
PPI YoY (%)	<1	2-3	3-6	6-10	>10
Core PCE YoY (%)	<2	2-3	3-6	6-8	>8
Unit labour cost YoY (%)	<1	2-3	3-6	6-9	>9

The Inflation Phazer gives each regime a monthly probability (see Chart 3), according to the values expected on each inflation index (see Chart 4).



According to Amundi's current macro forecasts, there is a 70% to 80% probability through 2023 of US inflation being in the Normal to Inflationary regime.

Conveying our top-down assessment into the Advanced Investment Phazer framework.

We have described all the ingredients of our cycle indicator, the Advanced Investment Phazer, which underpins our medium-term investment views. Within this framework, we bridge our views and expectations on the macro outlook to our convictions and investment strategy.

2. Investment Consequences: higher growth, higher rate and yield perspectives

US rates are an important factor in global financial conditions and impact the main asset classes. We analysed rates' historical distributions to find empirical consistency of rates dynamics with past recoveries and, eventually, to simulate forward-looking scenarios. Results are reported in Chart 5 below, where the histogram shows US10Ys probability distribution. Ranges are clustered according to the financial regimes (and their probability of occurrence) according to our expectations[1]. The continuation of the financial regime labelled "Recovery"

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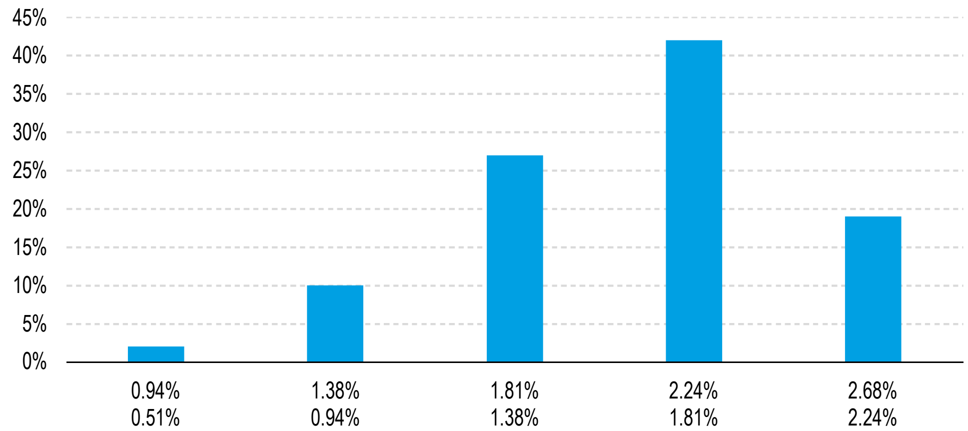
through H1 2022 implies a 42% probability for the 10Y US yield to fall in the 1.81-2.24% range (see Chart 5), in line with our expectations. In fact. **We have a target range for the 10Y US Ts around 1.8-2% over the next 12M.**

5/ **10Y US yield is expected to fall in the 1.81-2.24% range according to our economic regimes expectations (Recovery the central case)**



Source: Amundi Research. Data as of 16 April 2021

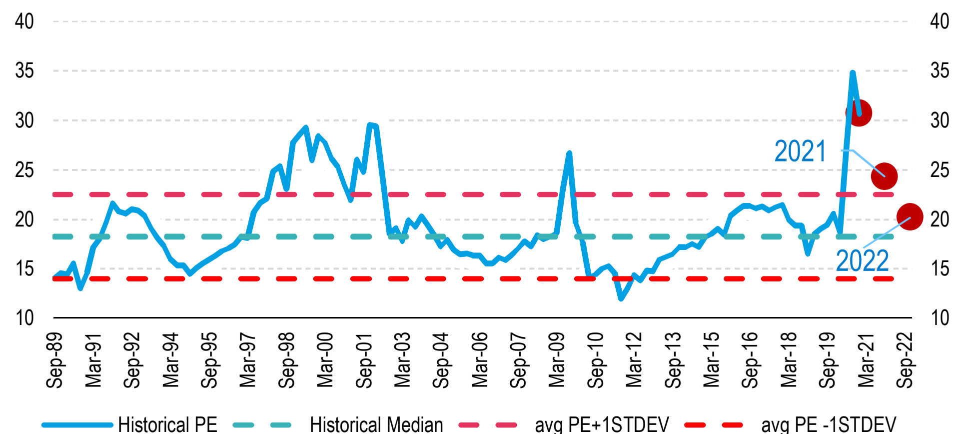
We expect the "Recovery" at the present time to be different from those seen in the past. Although the US economy is set to accelerate at a sustained pace, we expect the Fed to refrain from pulling back on its ultra-accommodative monetary support as long as tangible progress materialises in the real economy, the labour market recovers its slack, and inflation normalises around the central bank's target. As a matter of fact, the Fed has repeatedly emphasized that will be "outcome-based" rather than orienting its stance on forecasts, in part because of its experience during the last expansion, when inflation continually underperformed the Fed's expectation, but also because the high level of uncertainty surrounding the current outlook makes forecasts unreliable.

Such an outlook assumes that inflation will remain in check and not run out of control, therefore forcing an abrupt tightening intervention from the central bank (see Inflation Phazer box). Within this environment, **the search for yield is still the dominant theme** along the fixed-income spectrum. The focus is still on **emerging market bonds for diversification purposes and expected returns, although they have been historically vulnerable to US rate spikes.** We reiterate our preference for **inflation linkers** over government bonds. Inflation expectations remain anchored at low levels, and this is therefore a cheap hedge to have in case they move higher going forward.

> **Despite higher rates, in relative terms equities are the favourite pick within risky assets**

The **expected corporate earnings** recovery is the strongest argument in

6/ **The expected P/E should start to revert to less complacent levels going forward, moving below +1 STDEV by end 2022**



Source: Amundi Research. Data as of 16 April 2021

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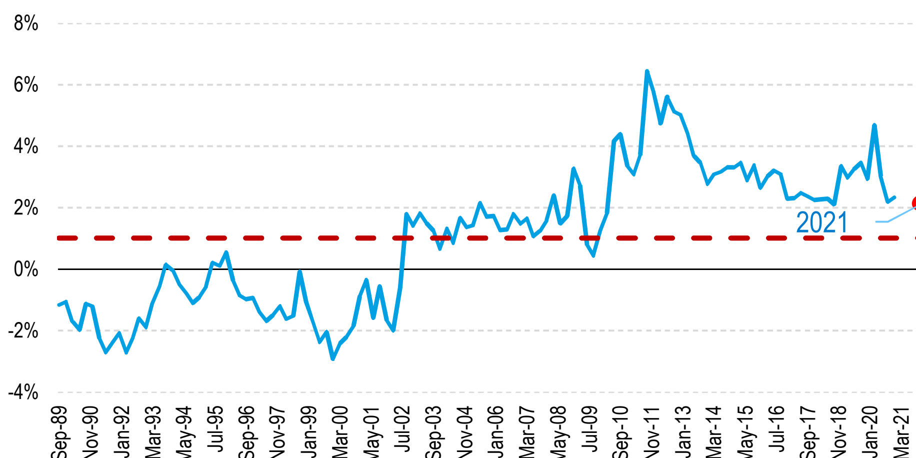
7/ **The equity risk premium (EY-10Y US) compressed recently but it should remain above long-term average in 2021**



Source: Amundi Research. Data as of 16 April 2021

favour of equities' upside, despite recent movement in rates, and our central case is closing the gap in the relative value metrics. The valuation gap has gone through different phases historically (see chart 6 & 7) and it's currently experiencing the regime that started with the Global Financial Crisis, when central banks began to deploy unconventional monetary policy tools (namely asset purchases resulting in balance sheet expansion). At 2% levels, the equity risk premium becomes very compressed and less supportive for equities vs Treasuries. We think that a combination of strong growth and subdued long-term inflation would be enough to maintain the focus on expectations and not on expensive valuations. For sure, this is a potential vulnerability for the equities outlook in the coming quarters.

Despite higher rates and expensive valuations, we expect the ongoing cross asset rotation from HY credit to equities, at least in developed markets, to continue. Current tight spreads and our forecasts are not consistent with HY returns similar to what equities can reasonably deliver, even when adjusting for volatility.

> Reality check on the continuation and sustainability of the rotation

According to our analyses, **the cross asset rotation will continue.** We recognise **a higher potential to the Eurozone when switching from HY to equities**, as the recent catch-up of this trade in the US has almost exhausted the relative appeal in the region. **Investment opportunities in the GEM risky assets spectrum remain in place in 2021, despite recent geopolitical issues, higher rates, and short-term dollar strength. Selection will obviously remain paramount.**

In light of these considerations, we feel it is appropriate to **maintain the "rotation" trade, focusing even more on lagging asset classes and playing this theme at the cross-asset level in order to guarantee the right risk diversification**. Financial conditions and relative value will continue to be monitored for risk as we approach summer.

Conclusion

We expect the goldilocks environment to continue to allow a tempered risk-on positioning despite risk assets stretched valuations. A key question for us is: what will be left after this "step-up" of activity and inflation. In this looming debate, we think that in the medium term growth will revert back to potential amid a higher inflation rate (at least in the US). This environment will prove constructive to risky assets, with credit potentially under pressure in relative terms should inflation stabilise above 3%. Not our central scenario, but still worth hedging via inflation linkers.

Finalised on 19 April 2021

[1] *Next-12M probabilities comes from the Advanced Investment Phazer. As economic cycles and financial regimes influence financial markets, we set them as the cornerstones of our scenario-based dynamic asset-allocation framework. We used growth, inflation, monetary aggregates and global debt to explore 120 years of history and clustered the dataset into five financial regimes: contraction, slowdown, recovery, late cycle and 'asset reflation', relying on unconventional policies. Each phase is identified in terms of distance from the macro risk factor and characterised by recurring persistency in returns streams. We identified some recurrences and consistencies whereby these regimes feature different patterns for financial markets not only in terms of asset class returns, risks and targets, but also in terms of cross asset interactions and exposure to relevant macro financial actors. Cesarini F, Defend M, Portelli L, The Advanced "Investment Phazer", 2011.*

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INVESTMENT STRATEGY

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