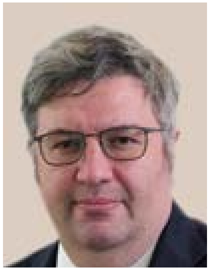
THIS MONTH'S TOPIC

Contraction > recovery > late cycle: the cycle round trip is confirmed Advanced Investment Phazer: top-down assessment

MONICA DEFEND
Global Head of Research



LORENZO PORTELLI
Head of Cross Asset Research

- **Economic and corporate-profit recoveries continue along a gradual, upward-sloping catch-up process, where growth speed and composition will be key to landing in a "recovery financial regime" towards year's end.**
- **Transition to the new financial regime will continue amid a sequel of relapses in the real economy, where policy boosters will prove critical, moving the needle between base and risk scenario.**
- **Over the next three to six months, while keeping the risk budget unchanged, progressively rotate risk from US HY into deep value/cyclical equities. Global IG remains supported by central banks' purchasing programs and offer palatable yields. Lastly, expansive monetary policies and safe haven nature will support gold.**

End of quarter assessment: what surprised us and what to expect next

The global recovery continues at different speeds and compositions at the regional level. Policies are pivotal in shaping the recovery trajectories, influencing market participants' narratives and rebuilding confidence.

In order to shed some light amid this global uncertainty, we believe it is helpful to have a look at what has been surprising us during the quarter:

1. **In the US, the Q3 technical rebound is exceeding our expectations on GDP, unemployment and housing market prints vs Q2, although still falling short of recovering lost output.**

   Some deceleration in high-frequency data late in the summer won't compromise the Q3 rebound, but is worth monitoring, as the speed at which economies will enter Q4 will be crucial to stretching the recovery into 2021. Global growth will be driven strongly next year by extraordinary base effects compensating the unprecedented 2020 Q2 losses.
2. In the US, fiscal policy is more diluted than expected with little visibility on the Phase 4 bipartisan deal in particular.
3. The speed at which new rules and new framework have been set up in the EZ on the budget, including a larger EU integrated budget, including the rescue package, temporary relapse of budgetary constraints at the national level to engage expansive policies, and the acceleration of the unconventional monetary policy mandate.

   All in all, the recovery path will progress along a **gradual, upward-sloping catch-up process**. **Relapses in the real economy will occur, and we expect policy intervention to take place hopefully at any juncture to allow a further step forward**.

Q3 set a strong technical rebound from the Q2 collapse in activity and confidence, although still falling short of recovering lost output

In our central scenario, this translates into pre-Covid 19 levels' not being reached for several more quarters on average (with the exception of China). A vaccine, which we expect to be available by mid-2021, would keep temporary damages from morphing into longer-lasting damage and thus would revive the recovery via greater confidence in both households and businesses. When compared to last quarter, we now have greater conviction in our base scenario (70% probability to deploy), while we emphasise the asymmetry of alternative scenarios (downside at 20% , upside at 10%).

During the quarter, inflation had been another relevant matter (but not a market mover), with the Fed delivering its new AIT (average inflation targeting) at a time when EU inflation readings were near historical lows (i.e., -0.2 % YoY in August). Attempts to anchor inflation expectations at higher levels look premature to us.

Inflation volatile in the short-term, trending higher and possibly episodically spiking next year.

In developed markets, inflation may experience unusual volatility in the months to come, due to lockdown-induced distortions. As long as the output gap remains open, global and local deflationary forces may put a lid on inflation, whilst the fading negative drag from the oil base effect will help inflation grind higher over next 12 months. For **DMs**, we expect inflation to remain subdued in the near term but to move higher into next year, due to the combination of: a) disappearing negative energy base effects; b) increasing input prices and cost-push pressures; and c) vanishing base effects of VAT cuts where implemented. In **EMs** as well, inflation started to pick up in July, driven mainly by supply shocks. Goods, and food in particular, are still playing an important

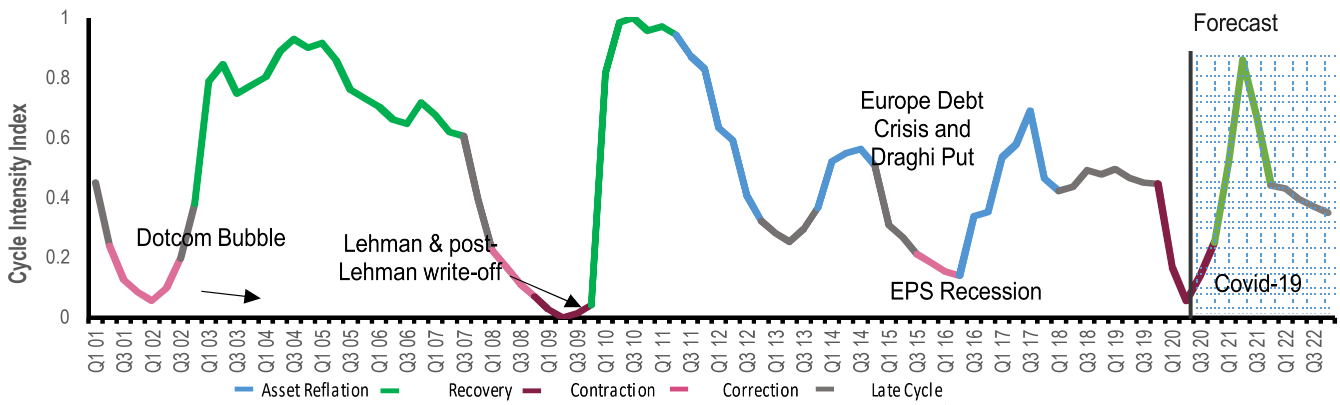
THIS MONTH'S TOPIC

Monetary policy is expected to remain accommodative

role in CPI baskets. **The overall picture is expected to remain benign, bringing headline inflation within CBs' targets;** however, prices dynamics are worth monitoring, given the huge dovish effort put in place by most CBs.

Monetary policy is expected to remain accommodative, with major central banks' playing a key role via almost unlimited QE, providing coverage of huge fiscal needs and acting to ensure liquidity to markets and the financial system. On the DM side, as expected, major central banks are revisiting their longer-term policy guidelines after constantly missing their inflation targets and thus allowing for extended periods of policy easing, even in case of modest upward moves in inflation. In the EM space, in contrast, monetary authorities have to balance their policies more carefully in light of very different inflation dynamics. While in the near term we see still very expansionary monetary policy with marginal easing in the laggards (e.g. Colombia, Mexico and Malaysia), we do expect a more stable MP on the back of a gradual recovery later on.

1/ Investment Phazer Dynamic - Smoothed



Source: Amundi Research - Data as of 18/09/2020

Financial regime mapping according to the investment phazer

Financial regimes	Macroeconomic parameters behaviour				Investment implications	
	Growth	**Inflation**	**Monetary Policy**	**Financial Conditions**	**Cross Asset Evidence**	**Cross Asset Preference**
Slowdown	• Growth below trend level • Below trend EPS growth	• CPI, PPI below trend • Falling ULC YoY growth	• Easy conventional MP • CBs balance sheet growth at trend levels	• Financial conditions start to be tighter	• Global equity suffer • IG preferred to HY in credit • Gold good hedge • Volatility increases	• Govies • Gold • Investment Grade
Contraction	• Growth far below trend level • Falling EPS	• Inflation far below trend	• CBs very accommodative • Excessive CBs balance sheet growth	• Tight financial conditions	• Credit and global Equity unattractive • Safe to quality • Lack of trust • High volatility	• Cash • Gold • Govies
Asset Reflation	• Growth at trend level • Above trend EPS growth	• Inflation below trend	• CBs very accommodative • Excessive CBs balance sheet growth	• Easy financial conditions	• Global Equity rises • Bond yields fall • Most assets do well • Volatility stays low	• Global Equity • High Yield • Commodities
Recovery	• Growth expanding far above trend level • Strong EPS growth	• CPI, PPI above trend levels • Above trend ULC YoY growth	• Tight conventional MP • CBs balance sheet growth below trend level	• Easy financial conditions	• Risky assets the most attractive • Commodities and EM Equity rally • High volatility	• High yield • Base Metals • EM Equity
Late Cycle	• Growth expanding slightly above trend level • EPS consolidation	• Inflation rises towards targets	• CBs correction (less easing)	• Easy financial conditions	• Bond yields rise • Global equity consolidates • HY rotation into Equity • Volatility Increases	• DM Equity • Investment Grade • High Yield

THIS MONTH'S TOPIC

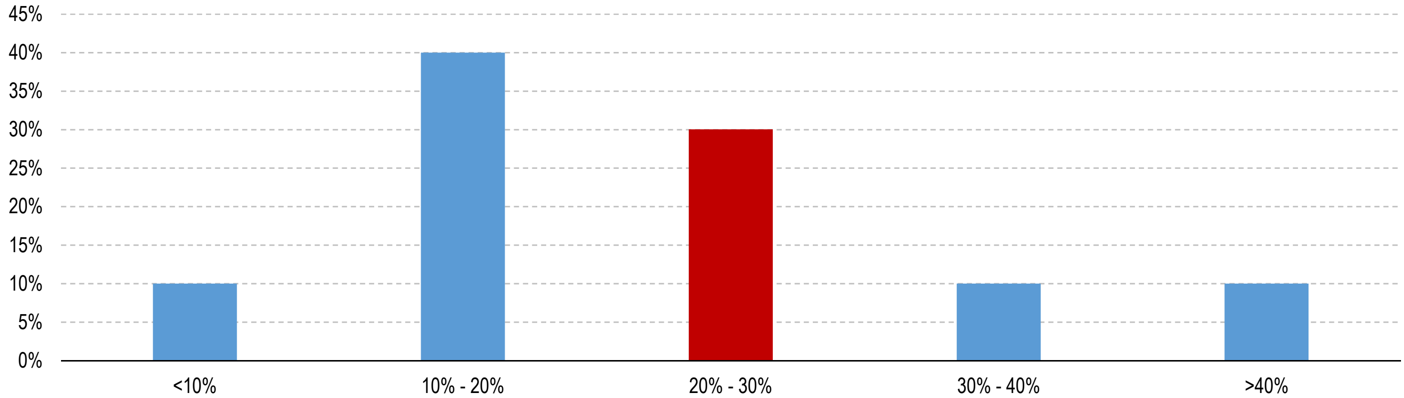
The time is coming to rotate risk

The fiscal response to contain the economic pain has been sizable in most advanced economies, and many emerging markets have also begun announcing significant fiscal support for the hardest-hit sectors. **Measures implemented will move debt-to-GDP ratios up by almost 20% in advanced G20 countries** over 2020, due to the combination of higher deficits vs. GDP (in the double-digit region) and an unprecedented GDP contraction. **A key role is being played by the ECB and Fed in absorbing the huge new debt issuance, managing QE's size and the duration of asset purchases**.

Advanced Investment Phazer (AI) medium-term implications

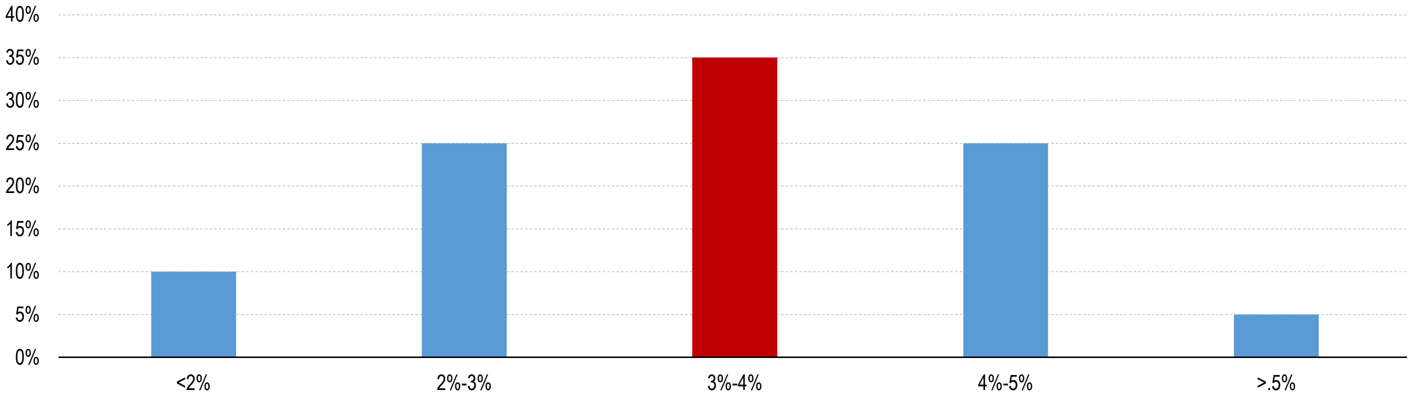
We described all the ingredients to our cycle indicator, the Advanced Investment Phazer, which underpins our medium-term investment views. As "recovery" is our central case, growth and macro determinants remain paramount. On our radar, the "contraction" regime remains confined to H120; the Q320 technical rebound will be short-lived; and the convergence of economic growth to pre-crisis levels will be slow and bumpy. EPS will be more resilient and faster in recovering to pre-crisis levels (in the US we expect to drift even higher to December

3/ **S&P 500 2021 Expected EPS Probability distribution (Red bar central case)**



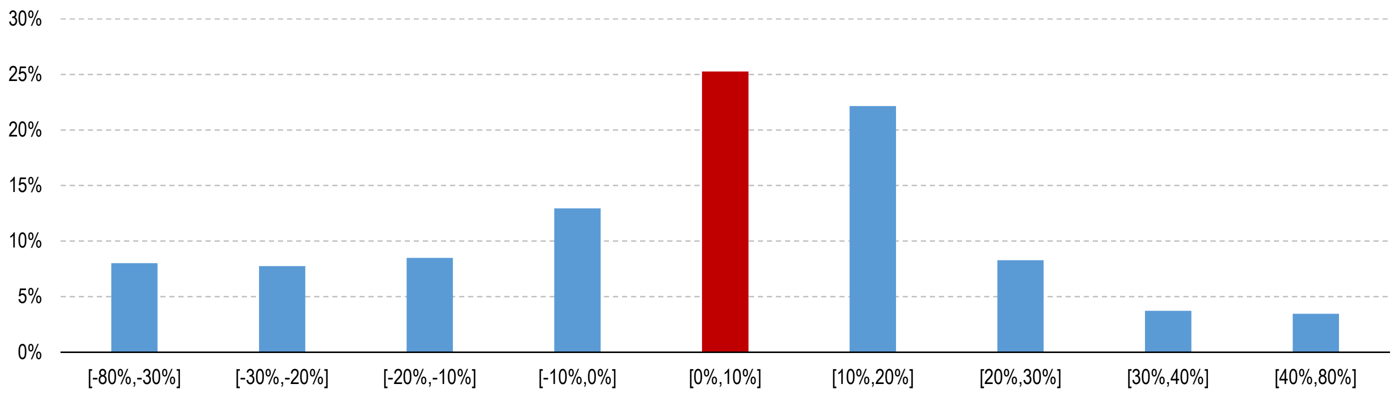
Source: Standard&Poor Website, Amundi Research - Data as of 18/09/2020

4/ **US Real GDP 2021 Expected YOY Growth Probability distribution (Red bar central case)**



Source: Bloomberg, Amundi Research - Data as of 18/09/2020

5/ **S&P 500 2021 Expected Returns Probability distribution (Red bar central case)**



Source: Bloomberg, Amundi Research - Data as of 18/09/2020

THIS MONTH'S TOPIC

2019 levels in 2021). Price dynamics will evolve from disinflation to below CBs' targets, with a potential spike down the road on components' base effect (oil). Policies accelerators are supporting risk assets, but the decoupling from their fundamentals increases downside risks.

While the central scenario remains that of a recovery in 2021, risks remain more skewed on the downside, given the uncertainty on the pandemic and the implementation of tax plans, mainly in developed countries. Until now, central banks have been able to buy time and let governments prepare the appropriate fiscal policy. Implementation will be decisive in returning to growth on more solid paths. The strength of the recovery will also depend on Covid developments and potential new lockdowns, should infections increase this autumn.

Within this framework, the search for yield remains valid but requires more diversification. Favoured by a weak USD, global emerging market bonds seem like a good opportunity. Moreover, central banks in emerging market economies are artificially keeping spreads low. We reiterate our preference for inflation linkers vs. govies, as inflation expectations are extremely low but should move higher going forward.

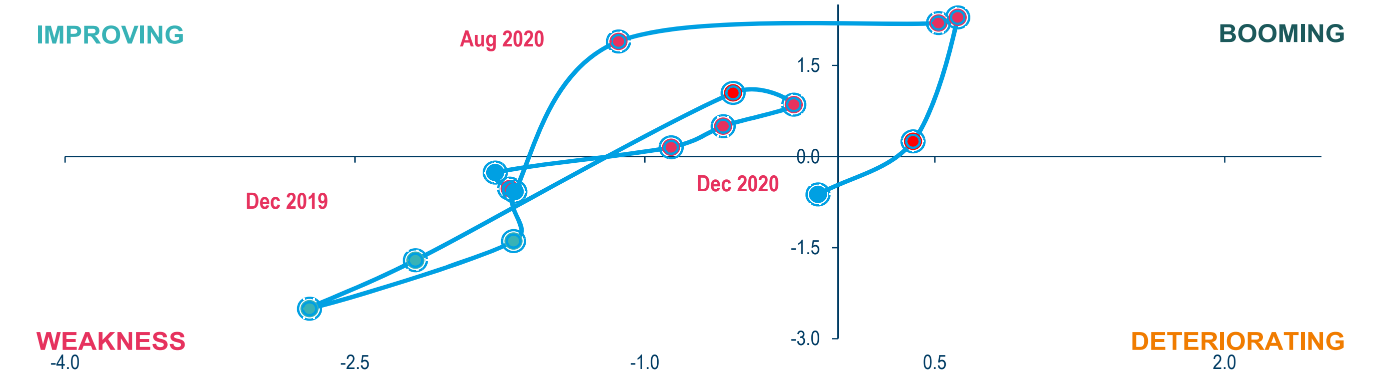
The resilience of earnings and market sentiment could help equities hit new highs in 2021-22 without stretching valuations. We expect P/Es to move to the median of historical realised P/E. As a consequence, equity markets will be appealing in relative value terms, as interest rates should remain low, helping credit to deliver acceptable risk-adjusted returns.

Advancing in Q4, state guarantees and financial support to the corporate sector will progressively fade, allowing fears of US and European corporate bankruptcies to build up. A sudden increase in default rates could hurt the high yield segment, whose spreads are tempered by central banks. Should this be the unfortunate case, we would expect central banks to prevent snowballing effects throughout the credit spectrum.

In light of these considerations, we think the time is coming to rotate risks amid risky assets, progressively shifting from high yield (namely low rated issuers) to equity (deep value, cyclicals).

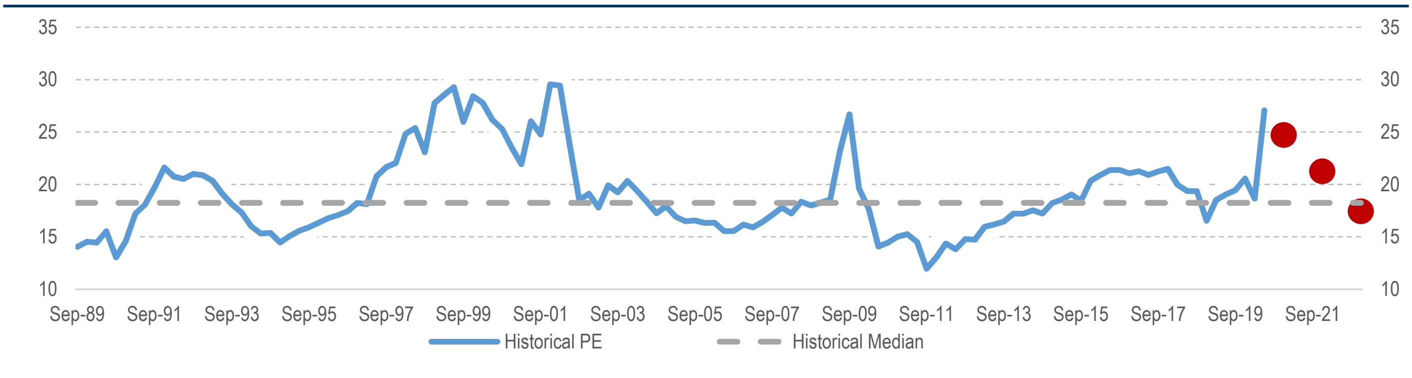
In this environment, growth, rates, inflation, monetary and fiscal policies are strongly interconnected. The potential mismatch of one could affect the results overall. If financial conditions remain as easy as they are now, the Fed will be unlikely to provide any further easing. As such, markets will be left with economic data, US fiscal stimulus , the US elections, Brexit and, obviously, Covid-19-related news.

6/ Global composite economic momentum set to rebound in Q3 20, supporting risk assets in H2



Source: Bloomberg, Datastream, Amundi Research - Data as of 02/09/2020

7/ Operating SP 500 PE (Actual)



Source: Standard&Poor Website, Bloomberg, Amundi Research - Data as of 22/09/2020

Amundi ASSET MANAGEMENT | Research

CROSS ASSET
INVESTMENT STRATEGY

October 2020 #10

Amundi Research Center

Find out more about
Amundi publications
research-center.amundi.com

Document issued by Amundi, "société par actions simplifiée"- SAS with a capital of €1,086,262,605 - Portfolio manager regulated by the AMF under number GP04000036 – Head office: 90 boulevard Pasteur – 75015 Paris – France – 437 574 452 RCS Paris – www.amundi.com
Photo credit: ©MDelporte - iStock/Getty Images Plus - Suriyapong Thongsawang

Chief editor
BLANQUÉ Pascal, *Group Chief Investment Officer*

Editor
DEFEND Monica, *Global Head of Research*

Deputy-Editors
BLANCHET Pierre, *Head of Investment Intelligence*
BOROWSKI Didier, *Head of Global Views*

With Global Research contributers
AINOUZ Valentine, *Deputy Head of Developed Markets Strategy Research, CFA*
BELLAICHE Mickael, *Fixed Income Strategist*
BERARDI Alessia, *Head of Emerging Markets Macro and Strategy Research*
BERTONCINI Sergio, *Head of FI and FX Research*
BLANCHET Pierre, *Head of Investment Intelligence*
BOROWSKI Didier, *Head of Global Views*
HUANG Claire, *EM Macrostrategist*
CESARINI Federico, *Cross Asset Strategist*
DELBO' Debora, *Global EM Senior Strategist*
DROZDZIK Patryk, *EM Economist*
GEORGES Delphine, *Fixed Income Strategist*
HERVE Karine, *EM Senior Economist*
LEONARDI Michele, *Cross Asset Analyst*
MIJOT Eric, *Head of Developed Markets Strategy Research*
LETORT Valérie, *Fixed Income Strategist*
PERRIER Tristan, *Global Views Analyst*
PORTELLI Lorenzo, *Head of Cross Asset Research*
USARDI Annalisa, *Senior Economist, CFA*
VARTANESYAN Sosi, *EM Senior Economist*

With the Amundi Insights Unit contribution
BERTINO Claudia, *Head of Amundi Investment Insights Unit*
FIOROT Laura, *Deputy Head of Amundi Investment Insights Unit*
DHINGRA Ujjwal, *Amundi Investment Insights Unit*
LICCARDO Giovanni, *Amundi Investment Insights Unit*
PANELLI Francesca, *Amundi Investment Insights Unit*

Conception & production
BERGER Pia, *Research*
PONCET Benoit, *Research*