Amundi Institute
ASSET MANAGEMENT

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A rocky net zero pathway calls for a new approach to portfolios

- **Uncoordinated policy actions point to an uneven path towards net zero greenhouse gas emissions. This could mean higher inflation in the short term and a more uncertain long-term growth outlook.**
- **Managing social costs will likely be key. A more just transition can be achieved by reallocating national income towards labour via higher wages.**
- **Bonds are back as potential portfolio risk diversifiers. Emerging market equities and real assets could help boost returns to levels that traditional 60-40 portfolios will struggle to deliver.**

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There's a growing global consensus on the urgent need to combat climate change. But governments' uncoordinated reactions to energy price spikes in the past year showed that a successful and orderly transition to a greener economy is far from guaranteed. **A 'disorderly' transition, driven by disjointed policy actions therefore weighs more heavily on our baseline scenario for this year's Capital Market Assumptions: 'A rocky net zero pathway'.** Limiting the rise in temperatures over the net zero 2050 horizon is the shared endgame, but disruptive themes will likely profoundly affect the real economy and financial markets.

In the near term, the energy transition could provoke bouts of inflation due to higher carbon and commodity prices. But we believe price pressures won't be persistent. A more lasting impact may be seen from a shift away from fossil fuels, technological changes, and initially lower productivity. This could dent domestic demand and may mean economic growth is more subdued in the medium to long term.

Central banks will likely be cautious about running down their balance sheets, but aggressively use short-term interest rates to counteract inflationary swings. Monetary policy will try to prevent debt levels from becoming explosive, while keeping long-term rates under control. Central banks' balance sheets will therefore stay well above pre-Covid levels. Sectors that are most closely linked with the green transition should be the biggest beneficiaries from policymakers' support - a sort of 'green' quantitative easing.

Recycling carbon tax revenues into climate-related activities that help households and firms may also offset part of the transition's negative impact on growth. This could translate into higher future productivity, while helping to mitigate social costs and pushback from the most vulnerable parts of the population. Managing the social costs will likely be key to the transition, as the effects of climate change are felt unevenly across communities.

A more inclusive growth model could be promoted by rebalancing the national share of income towards labour, without significantly affecting the economy. Higher wages will compress corporate profit margins. But higher disposable income will buoy household consumption and should help to support companies' revenue. **We estimate that a 7% increase in the labour share of income deriving from higher wages can be accompanied by less than a 10% decrease in cumulated profits over the next 20 years in most developed countries.**

New legislation aimed at decarbonising energy supply will affect emerging and frontier economies the most, while more developed and less carbon-intensive economies will cope by diversifying the composition of their exports. **Investment plans should therefore accompany the phasing-out of fossil fuels in countries and sectors where their legacy is strongest.**

In our view, investors should therefore factor in the implications of a shift towards a net zero world, driven by new policies, technology, and changing consumer preferences. The climate transition presents both risks and opportunities for investors, and energy transition themes will remain in the limelight for the foreseeable future.

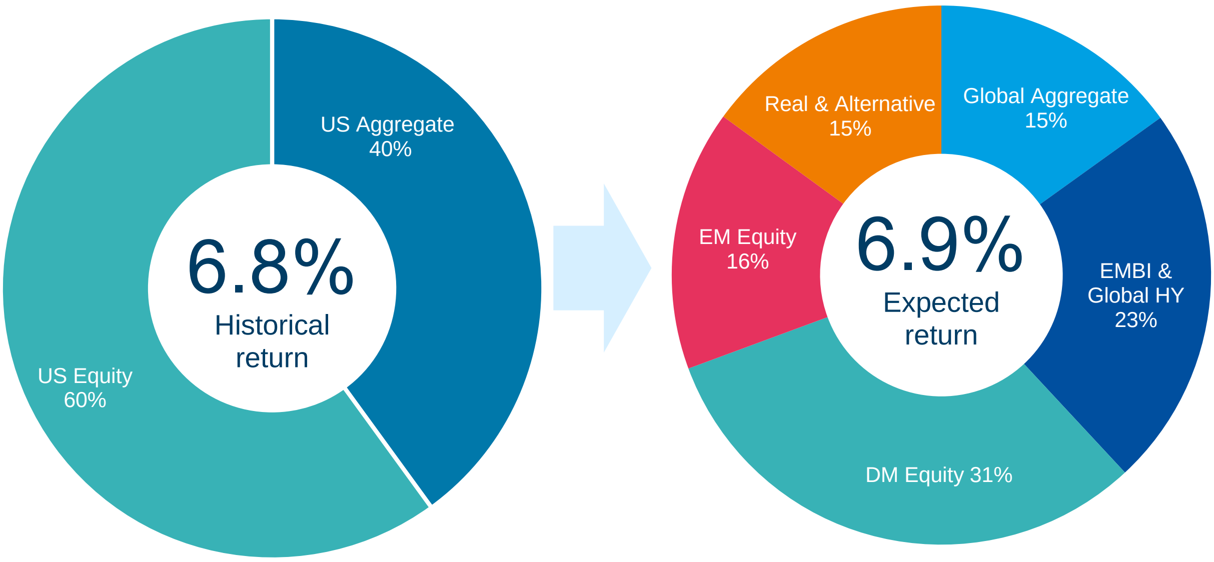
In an era of more urgent but less coordinated transition, we expect equity returns will be lower over the next ten years than in the past decade. But **emerging markets, particularly Chinese and Indian stocks, may offer interesting**

opportunities, while the US remains favoured among developed markets. From a sectoral perspective, we believe **the leaders in the green transition will be favoured** together with Information Technology, and the outlook for value investing looks positive.

After a lost decade, bonds are returning to their long-term trend. This is reviving their role as **a potential portfolio risk diversifier, although we anticipate higher volatility given greater uncertainty and a weaker economic outlook.** Investment grade credit could benefit from higher government bond valuations. Emerging market bonds can offer higher yields, but might be challenged by potentially higher default rates.

Real and alternative assets, as well as commodities, will also be crucial, in our view, for building inflation-resilient portfolios. Private equity, particularly in the US, tops our expected returns ranking while, on a risk-adjusted basis, global private debt is favoured. Hedge funds also may offer an appealing profile, having the lowest risk across the spectrum of real and alternative assets, and appealing returns. Real estate and infrastructure are vulnerable to the impact of climate-related events, but are appealing from a diversification standpoint, which may be key to targeting higher returns in an environment of higher risks.

A new approach that aims for returns that traditional 60-40 allocations can no longer deliver



Source: Amundi Institute from 2023 Capital Market Assumptions.

IMPORTANT INFORMATION