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Do not give up on fundamental valuations.

Something has to give in a regime shift. Be prepared, there will be opportunities for value investors.

Confidence must be earned

Amundi

ASSET MANAGEMENT

CIO Letter

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Today, most investors are at a loss regarding what to think of the notion of value and valuations and, even most importantly, how to use it in portfolio construction. **We are at the start of a sort of crisis in confidence regarding valuations** (and therefore also fundamentals, as they are interlinked) because few to no valuation indicators seem to be effectively working and irrational forces are perceived to be taking a prominent role in driving financial markets.

The temptation is to give up on value/fundamentals as a founding investment principle or to just consider short-term relative equity/bond valuations instead of more strategic absolute metrics.

Valuation metrics

Indicator	Cyclical / Non-cyclical	Function for investors
Relative equity/bond	Cyclical	Tactical asset allocation (AA)
Absolute equity	Non-cyclical	Strategic AA
Absolute bond	Non-cyclical	Strategic AA

Yet, we argue that long-term absolute valuations are key to building strategic asset allocation and they are even more relevant in an era of possible regime shifts. **What investors need is to further enhance their approach to absolute valuations.**

In this respect, **we believe they should enrich the traditional approach based on (real) fundamentals** (inflation, growth, earnings) **with the inclusion of a monetary factor** (as a dominant feature of the current transition phase) and **narratives as a foundation long-term expectations**. Real fundamental factors, though less prominent in this (monetary-oriented) regime, are not less relevant from a valuation perspective if 1) they are approached with a long-term, non-cyclical view in relation to expectations and 2) if they are broken into facts and narratives.

"As the probability of a regime shift increases, it is important that investors don't give up on fundamental valuations".

Narratives are adding (or subtracting) to a trend, reinforcing it or pushing it in a different direction. For example, the narrative of *low growth/no inflation* (secular stagnation) has shaped long-term expectations over the past decade, because it has been public, vocal and visible. **Moving forward, the emergence of a '*back to the '70s*' narrative can help modify long-term expectations even before (or beyond) what data shows**. This is why it is important to capture the dynamics of narratives and the emergence of new ones as they can help explain a deviation from equilibrium (by equilibrium we mean what is coming from fundamentals as defined by expectations on growth/inflation/earnings). **Therefore, we could enlarge the notion of equilibrium to include all the three pillars (monetary factor, real factors and narratives) as explanatory factors.** Combining these three pillars can help design scenarios and portfolio actions within a regime and across regimes.

"Narratives signal a possible turning point. Be prepared, as this is the time to play opportunities in the market."

At the same time when there is a deviation from equilibrium and a prevailing narrative signaling a change in regime, this points to an important turning point for investors: this is exactly what we are facing right now. In the second half of the year, we will likely reach a decisive moment with the acceleration of the vaccine distribution, the reopening of economies and the possible initial effective signals of accelerating growth and some inflation pick-up.

"The reassessment of market narratives, and of value, will be a key input when revisiting portfolio construction and it could also offer investments opportunities."

At this point, the current narrative of low growth/no inflation forever will be tested. This will confirm the dominance of the narrative pointing down the road to the 70s. In fact, today, in the transition phase towards a different regime, **for the first time in more than three decades narratives are explicitly expressing a preference for inflation** as a way out from the current crisis. In these narratives, inflation has ceased to be a negative. It is a desire. This will likely drive the materialisation of a higher inflationary regime.

When a preference across society and its institutions is being established, experience shows that the prevalent narrative becomes self-fulfilling and this often leads to a new mandate given to central banks. Former Federal Reserve (Fed) chair Paul Volker got his mandate to fight classic inflation when he was appointed in the late 70s. The new generation of central bankers will be asked to address new conflicting challenges, such as absorbing skyrocketing debt while dealing with an asset bubble generated by an excess of liquidity created by central banks themselves. The transition phases unsurprisingly see the co-existence of previous and new mandates. **The reassessment of these narratives, and of value, will be a key input when revisiting portfolio construction and it could also offer investments opportunities.** In fact, value is a key element as it forces the non-cyclical reasoning from two angles: what is beyond the 1-to-2 year fluctuation and what is a regime shift (to say it differently, a strategic long-term fluctuation, driven by non-cyclical factors).

Acknowledging the importance of looking at all three pillars (monetary factor, real factors and narratives) when assessing valuations, **we can draw some key investment implications:**

- **Bond valuations are stretched** and in excess of what long-term expectations for growth and inflation (the secular stagnation narrative) can justify.
- **Equity valuations are stretched** and in excess of what long-term expectations for earnings can justify, unless we embrace the "roaring 20s" narrative of higher productivity growth, similar to the one experienced at the beginning of last century.
- **Both bonds and equities are expensive versus their equilibrium level within the current macro/financial regime** – with equilibrium estimated relative to real fundamentals such as growth, inflation or earnings; **this deviation is mainly due to a pure monetary factor and narratives** (bond side mainly) reinforcing the trend. **As far as the monetary factor prevails, this phase is likely to continue in the short term.**
- **Stretched bond and equity valuations are likely to enter a zone of regime shift and change in equilibrium as current narratives progressively or suddenly turn into different ones**, that will establish a link with other components of long-term memory **(like inflation, the 70s, non-independent central banks).**
- **A redefinition of equilibrium is likely (pointing towards higher rates, lower returns for equities) with equities outperforming bonds.**
- **For investors, there is little value left within the current regime, while a relative value approach could provide additional opportunities.** A correction is to be expected to restore value within the regime through mean reversion. **Investors should consider locking in some capital so that they can deploy it later or lock it into the effective storage of value approaches** (value stocks). In the meantime, equities should be overweight versus bonds as indicated by cyclical yield-gap normalised measures.

Equities are overvalued, but as there are elements pointing towards a regime shift and higher inflation, and pressure for search for yield, equities remain critical from a strategic standpoint. It will be important to manage this transition from overvaluation towards a new regime while building a strategic equity allocation and to stick to the concept of value while doing this.

It's not time to give up on valuations

The strong rally in equity markets in 2020, despite the challenging economic and health backdrop led by the Covid-19 pandemic, has resulted in an increasing divergence between market behaviour and economic reality, as financial assets have continued to perform strongly.

"There is a strong detachment between the still weak economic environment and the exuberance of equity market valuations."

This detachment represents the first key juncture investors are facing this year and it is characterised by a further deceleration in economic activity (particularly in Europe where lockdown measures are pushing the economy back into recession during Q1 2021), while markets continue to price an acceleration in growth driven by the rollout of the vaccination campaign. Against this backdrop the key questions are:
Is this rally over or is it set to continue and how can we justify an extension of this trend at current valuation levels? This is the hot debate building up now and it is all about the relevance of valuations.

Figure 1. S&P500 price is detached from real economic fundamentals: Skyrocketing adjusted price to sales ratio[1]

Source: Amundi, Bloomberg. Data as of 12 February 2021.

"There is a temptation to give up on valuation metrics and justify the current market extremes on the basis of the reflation narratives."

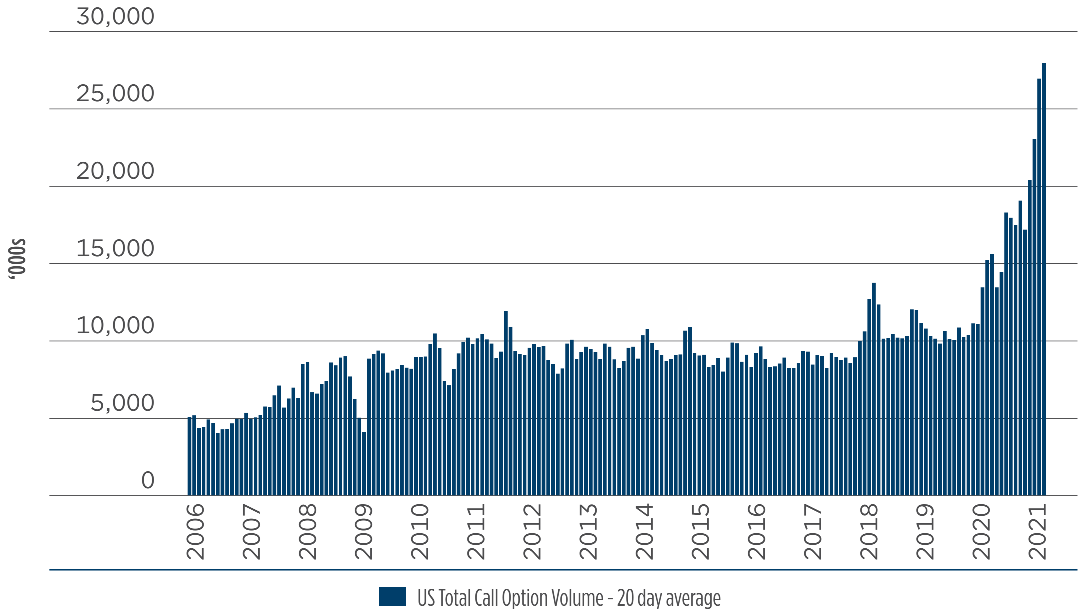
Looking at equity markets today, this detachment looks quite marked in the US. Yet, investors following the reflation narrative are tempted to justify this behaviour in light of the expectations of a greater fiscal push from the new US administration and from some moderate rise in inflation expectations mainly due to base effects (energy prices).

This juncture may lead to a short-term pause in the market rally, while the virus cycle accelerates and the rolling out of the vaccination campaign takes time. Yet, as the current market narrative continues to assume that negative economic news will support further monetary and fiscal expansion, what we call *bad news is good news* it is hard to see any significant trend reversal.

This year, the rush to buy stocks (as we see in Figure 2 related to the volume of option trade) is a case in point.

[1]Adjusted price to sales ratio is the Index Price / Sales calculated as Last Price divided by Trailing 12M Sales per Share.

Figure 2. Excess euphoria in record high Call Option volume in the US



Source: Amundi, Bloomberg. Data as of 12 February 2021.

The traditional value assumptions are based on the idea that there is value related to stable identifiable fundamentals, not necessarily observable, but that exert a sort of power of attraction over time. This idea has receded due to the rising view that markets are driven by irrational forces (psychological ones), far away from traditional fundamentals. Taken to the extreme, this view suggests that it is worthless tempting to forecast anything as this would be a waste of money, time and resources and would add little to no additional potential reward

Paradoxically, the school of irrationality and the school of market efficiency have reached some common conclusions. The first (irrationality) states that is better to go passive, to refrain from forecasting anything. The second (efficiency of markets) says that markets are inefficient and that value should help to exploit these inefficiencies. Yet, inefficiencies can continue to rise challenging the value approach, as extreme liquidity (driven by never ending Quantitative Easing) continues to cause distortions in the market.

What has receded is the idea of an identifiable long-term (future/expected) objective substance relevant to the effective behaviour of markets (the leading role of fundamentals) and that is something in addition to the interest rate/monetary factor. **What has gained ground, instead, is the idea of a more effective power of explanation of psychological forces and narratives.**

"Later in the year accelerating growth and inflation dynamics will lead to a moment of truth when the market will reassess the valuation of both equity and bond markets."

Investors should not see these approaches as mutually exclusive. Putting the concept of value at risk means also challenging all the long-term investment approaches that rely on value, equilibrium fundamentals and wealth creation over the long term. **It is not time to give up on substance over noise, but to enrich the value approach with the incorporation of a broader understanding of what drives long-term expectations.**

This is even more important because, later in the year investors, will reach a second key junction. The decisive moment will arrive when the economy eventually starts to reaccelerate and the inflation pick up starts to materialise. This will once again put valuations under the spotlight, both on bond and equity markets, as the real economic variables that underpin the concept of value (inflation, growth and earnings) will be reassessed on the basis of real data and not just on the basis of hope as it is today.

Revising the definition of value

"Investors are puzzled by the definition of value as it appears to not work anymore."

The concept of value is a core topic to address, especially at a time when there seems to be a sort of crisis of confidence regarding valuations (and fundamentals since they are linked). Understanding these doubts requires a step back to the definition of value and what investors associate with the notion of value.

Investors searching for value are mainly looking at two factors:

- **A store for value in the sense of some defensiveness**, margin of safety against what can go wrong which is implied in the cheap price of the stock;
- **The potential for future capital gains.** This materialises when there is a gap or deviation between the current price and some fundamental estimates of this price that should mean revert (and therefore close) over a sufficient long-term horizon.

Today, investors are puzzled by this definition of value. The crisis of confidence regarding value and valuations is, in part, due to the fact that **few to no valuation indicators are effectively working even at the extremes**, but it also driven by the difficulty to read the current valuation picture in relation to the overwhelming importance of interest rates in the current regime. The ineffectiveness of the most commonly used indicators make them useless for portfolio construction activity, and therefore investors have been looking to other factors (not the traditional real ones) to explain the recent market behaviour.

"Central banks' extraordinary monetary reaction to disinflation, and then deflationary tensions, has been the key market driver of this regime and has sanctioned the victory of monetary/liquidity factors over real factors."

There is a shared view that value has been – in this regime – essentially liquidity driven. The discount rate effect has been dominant. The valuation of equities – a leading indicator of the performance of equities versus cash – can be decomposed into the value of equities versus bonds and the value of bonds versus cash. The former (i.e., the interest rate) has dominated valuations, as central banks' extraordinary monetary reaction to disinflation, and then deflationary tensions, has been the key market driver and has sanctioned the victory of monetary/liquidity forces over real forces.

In addition, investors struggle to distinguish between what does not work about valuation indicators and fundamentals, and what is due to badly defined valuation indicators or fundamentals and what is structurally a problem with them.

For example, regarding earnings, the striking feature of the market industry is the importance given to the forecasting of short-term cyclical earnings, while this is irrelevant for long-term valuation assessment. In fact, since positive and negative fluctuations neutralise throughout a cycle, these are simply noise from a value standpoint. Yet, most of the so-called value indicators (PE, PBook...) are based on such short-term measures.

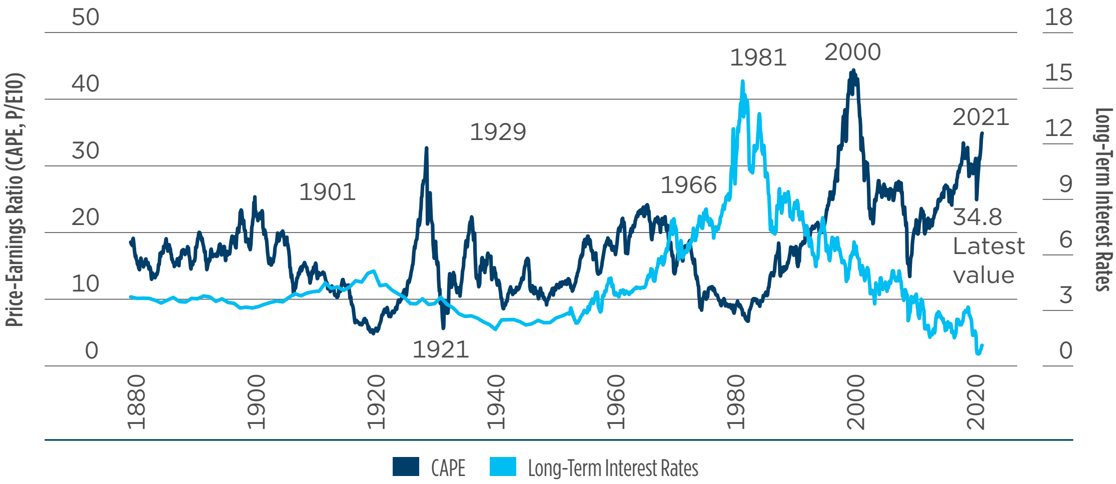
Similarly, long-term expectations are now challenged, as they appear to be a respectable concept, but not helpful given the difficulties in measuring them in line with some forecasting capabilities. The fact that most so-called value indicators based on cyclical short-term measurement simply do not work (in sending effective signals for investment) even at the extreme is compelling. **This tends to indicate that the ways expectations are defined is flawed and are built on weak inputs (e.g., simple surveys) and that the time framework of these expectations (often less than 2 years) is not relevant.** As we will see later in this paper, there are other variables and dimensions to take into consideration: narratives in relation to memory and forgetfulness being among the most promising candidates.

"It is difficult to interpret current valuations in a regime of extremely low interest rates and this is leading to revision of some leading valuation indicators as recently done by Robert Shiller with his CAPE ratio."

The dominance of the monetary factor has led to the temptation to "adjust" absolute indicators.

Looking at the leading valuation indicator, the CAPE[2] ratio, its current level is among the highest historically, similar to 1929 and lower only than the 2000s peak. Yet, the great difference with these previous occurrences is that today 10year Treasury yields are at historical low levels and not comparable with the previous episodes of high valuations, posing the question of how reliable is this indicator in this market environment.

Figure 3. Shiller CAPE vs Long-Term Interest Rates



Source: Shiller data as of 12 February 2021. http://www.econ.yale.edu/~shiller/data.htm

In the attempt to explain current valuations in the contest of falling interest rates, even the creator of the CAPE ratio, Nobel prize-winning economist Robert Shiller, has recently worked on revising his own indicator to try to make it more accurate. **According to Shiller, it is important to consider interest rates when valuing equities[3].**

Another element of complexity regarding value is that, just as for liquidity, investors do not know how to define precisely the notion of value and they do not know how to use it in portfolio construction.

As with liquidity, where there is a trade-off between keeping liquidity buffers for safety and giving up some potential capital gains from invested capital, there is a similar trade-off when it comes to invest in value. This is the trade-off between locking-in capital with a long-term horizon for defensive purposes (to have areas that should not be eroded in case of a worst case scenario and for some liability-driven pressure) or more offensive ones (waiting for value to be restored leading to capital gains), and deploying it right away.

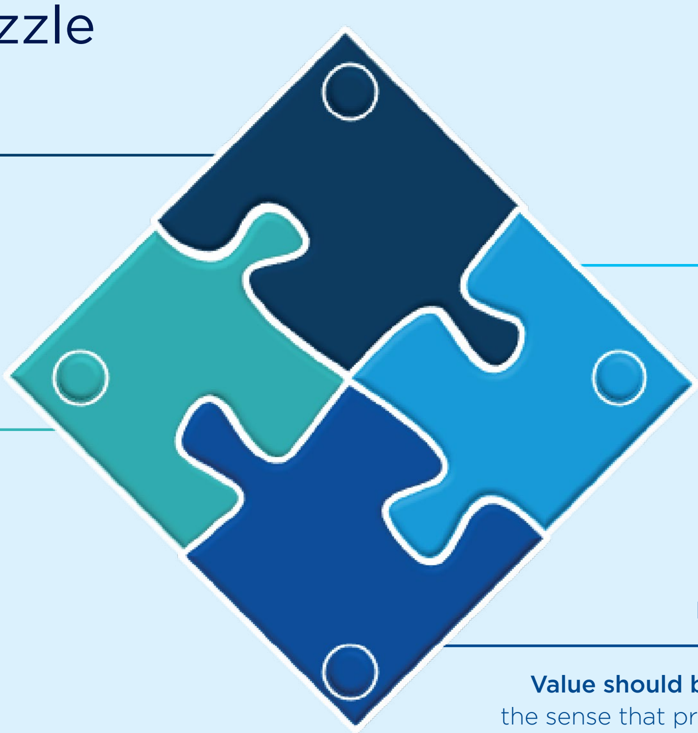
This trade-off is critical to portfolio construction and it is the key challenge investors will face this year. Is it time to trust or not valuations? What should the role of value be in the portfolio? Is value still valid or is it dead?

"It is not time to give up on valuations, but instead to try to enhance the valuation approach."

We strongly believe it is not time to give up on value/valuations. A proper definition of value combined with an enlarged scope that takes into consideration the current market environment (low interest rates) and narratives that drive market expectations, will provide, in our view, a helpful tool to design portfolios that can navigate a possible shift towards a new economic and financial regime.

[2]The CAPE Ratio (also known as the Shiller P/E or PE 10 Ratio) is an acronym for the Cyclically-Adjusted Price-to-Earnings Ratio. The ratio is calculated by dividing a company's stock price by the average of the company's earnings for the last ten years, adjusted for inflation.
[3]https://www.project-syndicate.org/commentary/making-sense-of-soaring-stock-prices-by-robert-j-shiller-et-al-2020-11?barrier=accesspaylog

The value puzzle



NO CLEAR DEFINITION

Most investors are struggling to define value, as it is hard to measure properly.

DOMINANCE OF INTEREST RATES

So-called "value" has been driven in this regime by the interest rate factor.

PERCEPTION OF EROSION OF VALUE

The perception that value has been eroded in markets is paradoxical as what is described as the key value driver is not fundamentals, but the monetary factor.

LACK OF FORECASTING POWER OF FUNDAMENTALS

Value should be to do with fundamentals in the sense that proper relevant value indicators, incorporating some fundamental variables, should show some forecasting power on financial asset returns. **This has barely been the case.**

The so what for investors

NEED FOR A RELIABLE DEFINITION AND METRICS

Need to have a proper definition of value combined with an enlarge scope that takes into consideration the current market environment (low rate regime) and possible market narratives (reflation)

NEED TO ASSESS THE VALUE TRADE-OFF

Need to assess the trade-off between locking capital in value with a long-term horizon or deploying it right away in different investment strategies.

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Spotlight on valuation metrics

"Value, long-term equilibrium and mean reversion form a homogeneous common set of notions that are key to portfolio construction for long-term investors."

Value should be connected to fundamentals in the sense that proper relevant value indicators, incorporating some fundamental variables, should show some forecasting power on financial assets return. This has barely been the case.

Many investors spontaneously acknowledge that value, long-term equilibrium and mean reversion form a homogeneous common set of notions. These features are key to portfolio construction for long-term investors and they should drive the strategic asset allocation (intended as a multi-cyclical period or a series of regimes). Every regime corresponds to multiple cycles having common features, variables and narratives and for which investors can identify an equilibrium for the key variables – real and financial – and prices.

To reassess the importance of valuation, we first have to **define which indicators are the most useful for investors in bonds and equities**. Three families – and scarcely more – of indicators have shown some forecasting power (in the sense that they mean revert).

1. **A relative value equity/bond cyclical or tactical indicator** based on the yield gap (normalised) that shows more forecasting reliability over horizons of 1-to-2 years.
2. **Two sorts of 'families' of absolute value indicators for equities and bonds:**
   - One inspired by **Shiller's CAPE** based on trailing earnings in equities;
   - **Another, for bonds, based on long-term (LT) expected growth and inflation taking memorised (trailing) inflation and growth as a proxy of LT expectations.** This is based with the idea that one forms expectations just like one forgets or remembers and this approach gives much better results than the set of short-term surveys of expectations or other cyclical measures. The indicator is built normalising over a certain period the deviation of the real interest rate (10-year yield or LT growth or inflation) from its LT moving average. This approach has a decent probability of capturing the stickiness of the evolution of expectations (it takes time to see change), of capturing the slow evolution of the equilibrium (i.e., the mean of the deviation) and of postulating some mean reversion of the deviation around equilibrium, which has historically been the case.

The two approaches have obvious common points in the sense that they attempt to maintain some core aspects of value: long-term expectations, equilibrium, mean reversion, a path towards value creation at investment horizon, real fundamental variables (growth, inflation, and earnings), the notion of a macro-financial regime defined by some equilibrium levels of variables and risk premia. Those features are key to portfolio construction for LT investors and we go in detail below.

Bond absolute valuation indicators

"Bond valuation indicators are based on the assumption that over the long term nominal rates converge to long-term growth/ inflation."

The most relevant family of absolute bond valuation indicators is based on the **normalised gap between nominal 10year yields and the long-term average of inflation as a proxy of LT expectations and the LT average of growth** (golden rule-based) as growth and inflation are the two main risks facing bond investors.

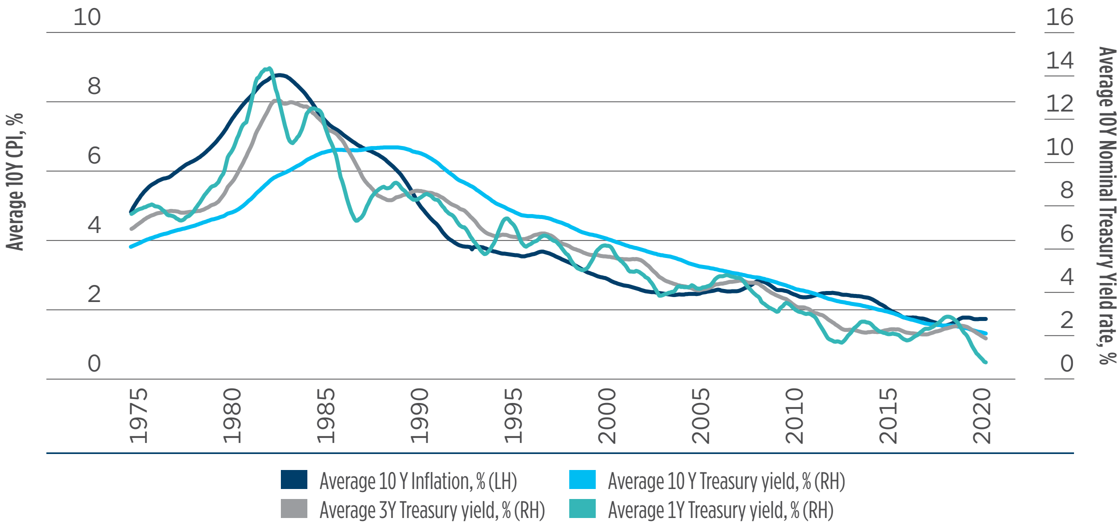
This approach is based on the assumption that mean reversion works on a sufficient long-term horizon, less so in this cycle (hence, this could raise some doubts in some cyclical phases). In essence, the **bond value indicator, as defined above, captures the deviation of the interest rate from some equilibrium level of fundamentals defined by growth and inflation.**

The maths of bond valuations	
Fisher's equation	Nominal interest rate = real rate + LT inflation expectations
Allais's golden rule	Nominal interest rate = LT growth rate + risk premium

10year nominal rates have fallen faster (monetary factor played a key role) than long-term memory (average) of inflation and growth as a proxy of long-term expectations. As a result, the equilibrium level of premia has followed a downward path.

"In periods of extraordinary monetary policy, the monetary factor may become the dominant one and give distorting signals: there is a risk of a wrong assessment in the case of a brutal/sudden regime shift towards a more inflationary regime."

Figure 4. Nominal yield and long-term average evolution versus inflation



Source: Amundi, Bloomberg. Data as of 12 February 2021.

This indicator may face the following limit. The pure monetary factor (money in the sense of pure Central Bank balance sheet expansion just like Quantitative Easing and other non-orthodox operations) may dominate over the real factor (growth, inflation), distorting somewhat the signal. For example, falling real rates may not necessarily signal a LT expected picture of low growth and inflation (as it is today), and instead would incorporate some pure monetary distortion. **This would imply for LT investors the risk of a wrong assessment of bonds in the case of a brutal/sudden regime shift towards a more inflationary regime.**

Equity absolute valuation indicators

"Similar to bonds, the CAPE ratio in equities is based on the assumption that over the long-term mean reversion will prevail."

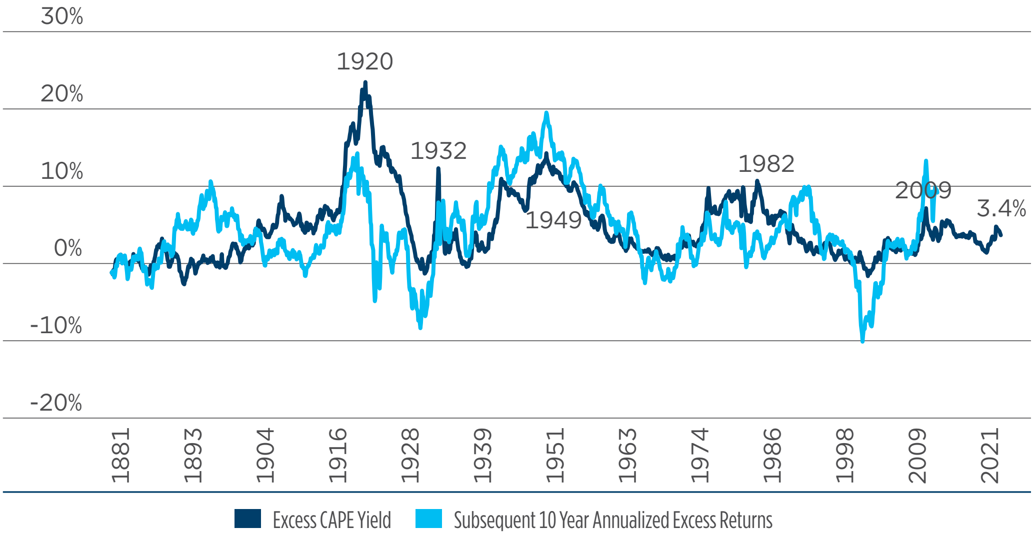
The most relevant absolute indicator, in our view, is based on trailing earnings and is developed essentially around the same approach as for bonds (LT past memory is used as a proxy for LT expectations coupled with an adaptive mechanism). Yet, as a prolonged low-rate environment can challenge the efficacy of this indicator to assess absolute valuations, **a relative value approach of Equity versus Bond (E/B) valuation is gaining traction**. Even Shiller, as previously mentioned, has revised the CAPE integrating this E/B relative value dimension to account for the relative yield gap element in relation with the interest rates, **acknowledging the idea that, all being equal, low interest rates at equilibrium can support higher valuations of risky assets at equilibrium.**

The relative equity versus bond valuation approach

The equity versus bonds preference is the driver of the relative performance of equity versus bond (E/B) and it is based on a cyclical indicator (1-2 years horizon). Its monetary (yield gap) and real (expected cyclical fluctuations) components are short-term and therefore the expectations built into it are also short-term in nature. This indicator is useful to determine the tactical relative E/B allocation over cyclical horizons. Though a real component lies in the expectations of cyclical fluctuations, this indicator is essentially driven by a monetary factor (cyclical) and is more of a liquidity than a value indicator as we define it. The new indicator, **the Excess CAPE Yield (ECY)** is the inverse of the CAPE minus real bond yield. **While CAPE is an absolute valuation indicator, the ECY is a kind of risk premium that helps predict relative E/B performance.**

"The Excess Cape Yield (ECY) is a relative Equity vs Bond indicator that currently supports the view that equities will likely outperform bonds."

Figure 5. Excess CAPE Yield (ECY) and Subsequent 10year Annualised Excess Returns of Equities versus 10year Treasuries



Source: Amundi, Shiller. Data as of 12 February 2021.

This supports the idea that the E/B preference is a key driver of the cyclical component of equity returns, when monetary factors dominate real factors.

The implications are that investors should look at the E/B yield gap, properly normalised over a relevant "regime" or "cycle" time frequency period, in order to define some equilibrium and fluctuations (mean reversion) around the equilibrium.

Based on this

1. The E/B preference and performance, because it incorporates expectations about the cycle (cyclical expectations) has some forecasting power on the real cycle – and this is documented.
2. The E/B yield gap determines the E/B preference and performance from a cyclical standpoint, as the Figure 5 shows.

This ultimately would suggest that:

- The entire sand castle of valuations would lie on relative value (the relative value of any risky asset class versus bonds) as its most reliable pillar.
- This relative value engine is essentially a cyclical tactical tool for portfolio construction.
- This relative value approach is more of a liquidity approach than a value one.

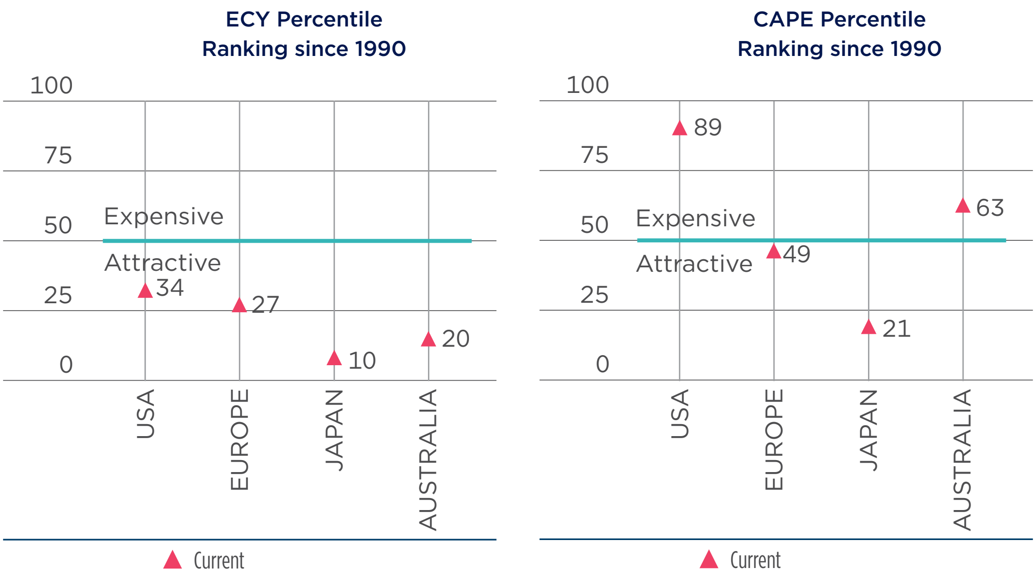
Looking at the current cycle, **according to the ECY indicator equities appear relatively cheap on an historical perspective versus bonds, and even more so in the more cyclical markets, such as Japan, Australia and Europe, despite much richer absolute valuations implied by the traditional CAPE (especially in the US).**

Currently, it seems that markets have replaced the relevant absolute valuation indicators with a single E/B relative valuation dispersion, with a shortening of the horizon (cyclical versus long-term) and no or less insight on absolute long-term paths.

"Today valuations for the US equity market can only be explained from a relative value (equity versus bond) perspective."

The current picture shows clearly that the ECY indicator is a relative valuation metric, while it does not imply much about absolute valuation, where CAPE is still relevant.

Figure 6. Excess CAPE Yield (ECY) indicates equity are cheap versus bonds, while CAPE suggests they are not so cheap on an absolute basis (and the US is the most expensive)



Source: Amundi Research, Datastream. Data as of 9 February 2021.

This approach somewhat complements the traditional one and suggests that valuations have two faces.

- On one side, we have the valuation metrics relying on the relative value approach (the relative value of any risky asset class versus bonds) that are cyclical tactical tools for portfolio construction.
- **On the opposite side, we maintain the view that value is about the non-cyclical (long-term) component of fundamentals and returns.** This structural perspective is the one that should drive the so-called strategic allocation. The assumption is that the long-term horizon is made of multiple cycles or even a series of regimes (in the case of a very long horizon), where every regime corresponding to multiple cycles has common features, variables and narratives and for which an equilibrium can be identified for the key variables, real and financial, and prices.

"While the relative value approach is relevant to capture specific regime features, it is key not to give up on the structural long-term perspective of value. This is even more relevant in a possible regime shift, such as the one we are currently living in."

Limits for absolute and relative valuations metrics and how to overcome them

The main limit (for strategic portfolio construction purposes) of the relative E/B value approach lies in its cyclical nature (more a liquidity than a value indicator, mostly driven by the monetary/interest rate component). The criticism of Shiller ECY is that it is no longer an absolute valuation indicator, as it helps to forecast the performance of equities over bonds, not equities over cash. The emergence of this new indicator does not imply that the absolute CAPE has stopped working forever.

The limit for absolute equity or bond indicators, instead, is the underestimation of the interest rate/discount rate factor (the main reason why Shiller has recently proposed a relative 'excess yield' adjustment to his CAPE approach).

We lack an effective value indicator for equities, one that would incorporate expected long-term variables in their non-cyclical component (assuming that the postulate "value is about long-term expectations, equilibrium and mean reversion around equilibrium holds off) and would really help forecasting returns on equities versus cash.

"A combination of both relative and absolute views is crucial and investors should not abandon the strategic perspective to embrace only the cyclical one."

In its absence, **an effective tool is a combination of relative value between equities and bonds and the absolute value of bonds.**

The signal obtained at a 2-year horizon for relative value does not hold for bond value. This means, as it is the case today to an extent, that attractive E/B value and poor absolute bond value, **should lead to a positive cyclical preference for equities as poor bond value is not expected to unfold at short-term horizons, though it can be the case.**

This holds even more when equities and bonds are substitutable/interchangeable as an asset class – i.e., a distinctive feature of regimes where monetary/inflation – disinflation/ interest rate factors dominate.

Beyond the cyclical view, it is crucial that investors do not abandon the strategic perspective to embrace only the cyclical one.

Acknowledging the importance of the structural view of value for strategic portfolio construction is key, as it forces us to look at what will lie beyond the short-term fluctuations and at a possible regime shift (a strategic long-term deviation) driven by non-cyclical factors.

This is more relevant than ever, now, as we come from a long regime of low inflation and falling interest rates supporting bond markets.

However, as we have also pointed out in the past (Covid-19: the invisible hand pointing investors down the road to the 70s), this pandemic could trigger a structural regime shift towards a new regime.

2021 could be the year that prove that this transition is occurring and that the market narratives that have been the foundation of long-term expectations for bonds and equities up to now, might be about to change.

The role of narratives in valuations

"Market narratives are a key driver of long-term expectations as they bring memories of past history and perceptions of current facts."

Market narratives give the sense of facts, perception, memory and forgetfulness, images and representations and, therefore, they offer a fertile ground to assess long-term expectations and are key in assessing value in its long-term aspect.

Table 1. Core features of narratives

Time horizon	SHORT and LONG-TERM
Apply to traditional fundamentals	YES and NO
Proxies of long-term expectations (they incorporate memories)	ALWAYS
Perceptions that may engineer facts	YES and NO
Driven by forms of multi-secular memory and forgetfulness	ALWAYS

Source: Amundi.

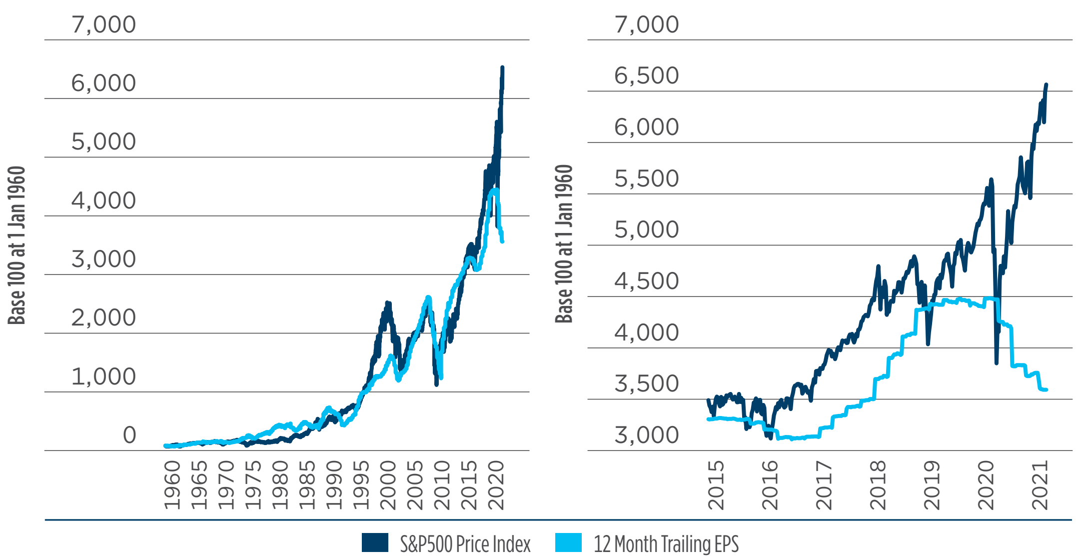
Narratives are interconnected and they are also dynamic as they evolve over time. Shifting narratives are signalling turning points, even more when value is already poor.

"Covid-19 crisis has only temporarily helped close the gap between rising equity prices and slowing earnings growth."

Looking at the past decade, the narrative of low growth, low inflation has dominated, making the monetary factor (discount rate) the key driver in this regime.

- In bonds, the monetary factor has sent valuations in excess of what could be justified by LT growth/inflation expectations that are already low.
- In equities, the monetary factor has also been dominant and has sent valuations in excess of what could be justified by earnings at trend.

Figure 7. The diverging path of equity prices and earnings growth



Source: Amundi, Bloomberg. Data as of 12 February 2021.

"The divergence should at some point close, but this realignment could come in different forms."

The Covid-19 crisis is leading to some new emerging narratives (see also the paper "Post-crisis narratives that will drive financial markets") and it is providing a typical example of when the short-term bias prevails over the long-term expectations.

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This is evident in the recent great divergence between the S&P500 price trend and the earnings growth trend. The Covid-19 crisis helped to reabsorb this divergence in early 2020 at the start of the crisis, but since then the patterns of S&P500 prices and earnings have deviated again to reach new extremes.

These extreme deviations have been closed in the past thanks to a mean reversion process. If this were to happen again we could expect equity prices start to increase less than earnings or even decrease, as it happened in the 2000s (with the dark blue line in Figure 7 moving back towards the light blue line).

The current price trend could persist, instead, if future earnings reaccelerate to the upside (with the red line catching up, as it happened in the 2017 to 2019 period) due to the unfolding of some 'revolution' in profitability.

The closure of the current disconnect is linked to three possible narratives (that could also in some cases coexist or be interlinked) that would support either the first convergence pattern (prices moving down versus earnings – the dark blue moving towards the light blue line) or the second one (earnings accelerating – the light blue line playing catch up).

The current presence of these three narratives is supported by the evidence of recurring language used in surveys and mentioned in news articles (tested with Artificial Intelligence).

Narrative 1. Growth/inflation trade off

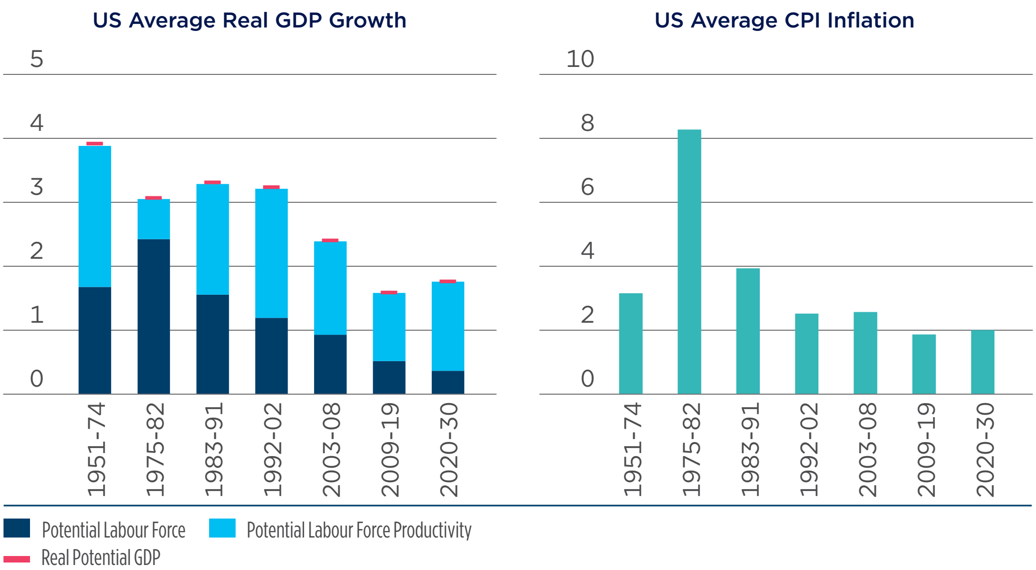
From secular stagnation to the road back to the 70s?

"The deflationary consequences of the 2008 crisis have helped build the secular stagnation narrative. The inflation pressure from protectionism and post Covid-19 value chain disruption and the monetisation of debt are driving the new road back to a 70s narrative."

The narrative

According to this narrative, forever-low growth and low inflation (with a bias towards deflation) is the anchor of long-term expectations for both equities and bonds. In this case, the only way to justify current apparently demanding valuations is to embrace a relative value approach and acknowledge the dominance of the monetary factor. The foundation of this narrative relies on the long-term memory of what has been the effective story of developed economies throughout centuries into modern times, when we exclude the inflationary episode of the 70s (and to some degree the wars). The general story is one of weak growth with no inflation and risk premia showing that equities are riskier than bonds. We could call it the narrative of the multi-secular memory of growth and inflation. The deflationary consequences of the 2008 crisis may have strengthened this narrative, adding an important short-term memory dimension to this long-term trend (the long-term memory).

Figure 8. Long-term growth and inflation dynamics



Source: Amundi, Bloomberg, CBO. Data as of 12 February 2021.

The evolution of the narrative

The multi-secular memory narrative includes the memory of the regime shift from a low growth/low inflation environment towards a high inflation one of the 70s, and it could well develop at some point in a "Road back to the 70s" narrative characterised by higher growth and higher inflation (even if it is probably not going into a hyperinflationary environment). The seeds for this regime shift rely on pre-existing trends, such as the increase in protectionism from the Trump era, but it is further reinforced post Covid-19 due to value chain disruption, rising demand for a minimum living wage and the monetisation of debt. These are all elements that could push inflation higher.

What to watch

Changes in inflation, inflation expectations and growth dynamics.

Investment implications:

The long-term implications of this narrative evolution into the Road Back to the 70s are:

- Bond yields should be higher at equilibrium, challenging returns in bonds even more compared to previous episodes of rising yields given the current low level of yields.
- Equity returns should be lower compared to the past decade of secular stagnation or could even turn negative in the initial phase of a regime shift.

Narrative 2. Technological revolution

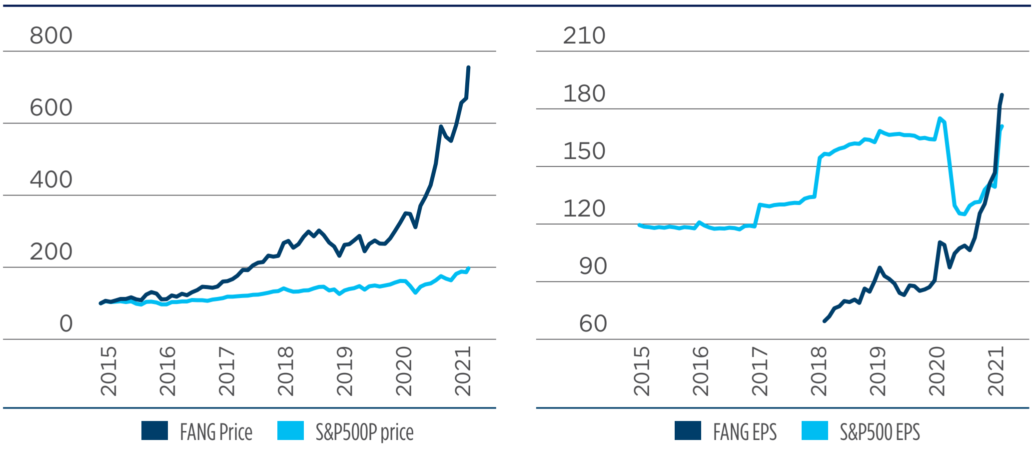
From creative destruction to secular stagnation?

"The market is seeing the extraordinary performance of big tech stocks as the seeds for the creative disruption narrative. Yet, it is difficult to imagine productivity gains able to explain an accelerating path of earnings growth above trend. Most likely, the confirmation that productivity growth remains sluggish could lead to the evolution of this narrative back into the current secular stagnation."

The narrative

The assumption behind this narrative is that a sort of creative destruction process is occurring, going hand-in-hand with a productivity boom (lagged and missed initially due to some mis-measurement or to the temporary effects of Covid-19 restrictions) unleashed thanks to the tech revolution and innovation. This narrative also has a long-term memory feature linked to past technological revolutions in relation to growth (the roaring 20s).

Figure 9. The recent impressive growth of FAANG earnings and prices versus S&P500



Source: Amundi, Bloomberg. Data as of 12 February 2021.

The evolution of the narrative

On earnings, the assumption that they will deviate upward thanks to technological revolution seems unlikely assuming the current trend in labour force growth, stock of capital and productivity and the high share of profits on value added. In order to return to a phase in which physical capital rises further, productivity gains would have to jump, with all else remaining constant (see also "*US earnings: learning from the past to look into the future*"). The narrative, in part, is based on a false representation of the economy in the index, as the S&P500 is not representative of the US economy, but reflects the trend of a few big global tech companies accounting for a significant portion of the index. Yet, assuming that the extraordinary earnings growth of the FAANG segment will translate into equivalent growth for the full market may be an overly optimistic assumption. Real fundamental factors (growth, inflation, earnings), though less prominent in the current (monetary-oriented) regime, are not less relevant from a valuation perspective if they are approached with a long-term view in relation to expectations and they are broken into facts and narratives. Therefore, should growth remain sluggish after the first bounce after Covid-19, we may end up moving back to the "secular stagnation" narrative of low growth and low inflation leading to the bubble being burst.

What to watch

Changes in earnings growth dynamics, productivity growth.

Investment implications:

The long-term implications of this narrative evolution towards secular stagnation are:

- Bond yields should stay low at equilibrium.
- Equity returns should readjust on the downside to absorb the excess optimism in a bubble burst scenario driven by the partial (and even minimal) withdrawal of extraordinary monetary measures.
- Bonds should outperform equities.

Should the creative destruction narrative prevail instead, the implications would be:

- Bond yields should be higher at equilibrium as growth should rise.
- Equity returns should stay on the current path as earnings growth should accelerate
- Equities should outperform bonds.

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Narrative 3. The monetary narrative

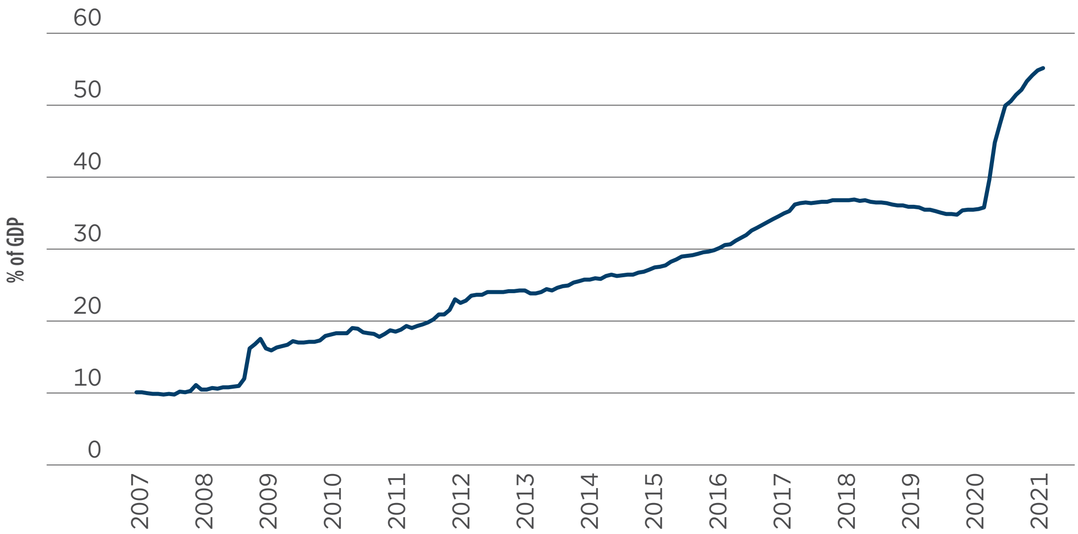
From orthodox/anchored to magic/de-anchored central banks?

"This third narrative is all about central banks and their mandate evolving from being anchored to keep inflation under control to moving towards extraordinary monetary policy becoming the new normal. This narrative is more advanced and supports the evolution towards a road back to the 70s regime."

The narrative

This third narrative assumes that rates, inflation expectations and monetary policy will stay accommodative forever, thanks to this magical central bank monetary stance. This would bring a significant change to the monetary narrative, deeply anchored at the core of the regime initiated by the arrival of Mr Volker at the helm of the Fed in the late 70s. This would explain why debt is no longer being seen as a negative aspect of the previous narrative, but rather as the solution and not a problem anymore.

Figure 10. G4 central banks balance sheet in % of GDP



Source: Amundi, Bloomberg. Data as of 12 February 2021. FED + EC + BOJ + BOE.

The evolution of the narrative

The central bank monetary narrative is already in the process of moving from the "control of inflation mantra" (orthodox/anchored CBs) to a "new extraordinary policy normal" (magic/de-anchored CBs). With fiscal and monetary goals strictly interconnected, this narrative is also pushing towards higher inflation and therefore helping the first narrative evolve into the road back to the 70s.

What to watch

Central bank policies and guidance, areas of loss of independence.

Investment implications:

The long-term implications of this narrative evolution are:

- Bond yields should be higher at equilibrium.
- Equity returns should be lower compared to the past.
- Equity will still provide better performance compared to bonds.

Alternatively, should inflation continue to remain subdued, leading to the persistence of the deflation-prone type of macro-financial regime that has taken place recently, the implication would be:

- Low yield equilibrium levels and a continued path of adjustment of equilibrium to lower levels.

The interconnection of narratives...

N1

Growth and inflation trade-off

The deflationary consequences of the 2008 crisis have helped build the secular stagnation narrative. The inflation pressures from protectionism and post Covid-19 value chain disruption and the monetisation of debt are driving the new road back to the 70s narrative.

Secular stagnation

Road back to the 70s

N2

Technological revolution

The market is seeing the extraordinary performance of big tech stocks as the seeds for the creative destruction narrative. Yet, it is difficult to imagine productivity gains able to explain an accelerating path of earnings growth above trend. Most likely, the confirmation that productivity growth remains sluggish could lead to the bubble bursting and the re-emergence of the secular stagnation narrative.

Big tech supremacy

Creative destruction

Bubble burst

N3

The Monetary Narrative

This third narrative is all about central banks and their mandate evolving from being anchored to keep inflation under control to moving towards extraordinary monetary policy becoming the new normal. This narrative is more advanced and supports the evolution towards a road back to the 70s regime.

Orthodox/ anchored CBs

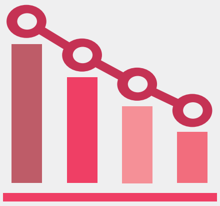
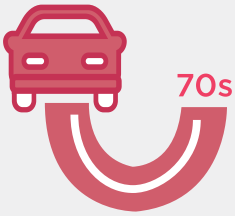
Magic/ de-anchored CBs

Monetisation of debt by CBs is another factor pushing the road back to the 70s

Lending regime

"Today, the coexistence of the monetary narrative coupled with the consequences of Covid-19 is creating a fertile ground for a shift towards a higher inflationary regime, a sort of back to the '70s scenario."

...and their potential outcomes

Regime	What to watch	Investment Implications
Secular stagnation 	Lack of earnings growth, GDP data, monetary policy	■ Bond yields should stay low at equilibrium ■ Equity returns should readjust on the downside to absorb the excess optimism in a burst bubble scenario driven by the partial withdrawal of extraordinary monetary measures ■ Bonds should outperform equities
The road back to the 70s  	Changes in inflation, inflation expectations and growth dynamics	■ Bond yields should be higher at equilibrium, challenging returns in bonds even more compared to previous episodes of rising yields given the current low level of yields ■ Equity returns should be lower compared to the past decade of secular stagnation or could even turn negative in the initial phase of a regime shift
Creative destruction 	Changes in earnings growth dynamics, productivity growth	■ Bond yields should be higher at equilibrium as growth should rise ■ Equity returns should continue on the current path as earnings growth should accelerate ■ Equities should outperform bonds
Magic/de-anchored CBs 	Central banks policy and guidance, areas of loss of independence	■ Bond yields should be higher at equilibrium ■ Equity returns should be lower compared to the past ■ Equities will still provide better performance compared to bonds

Source: Amundi, as at 15 February 2021.

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Implications for investors in a regime shift

"The new value approach based on the combination of the three pillars (monetary factor, real factor and narrative) helps define the equilibrium levels for a given regime and possible regime shift."

As we have seen before, absolute bond and equity value indicators are non-cyclical (long-term, over 1-2 years, at least an average 4-5 year cycle and surely above), they can be broken into:

- A pure monetary factor (LT);
- A pure real factor (LT);
  - In relation to traditional fundamentals such as growth/inflation (bonds) or earnings (equities)
  - Expressed in terms of LT expectations (of growth, inflation, earnings)
  - And LT expectations being defined using memory and forgetfulness (past averages, trailing…).
- Narratives across the first 2 pillars, monetary and real (narratives can be considered as part of the state of LT expectations since rising narratives are mobilising memories which are a key element to the formation of LT expectations).

Considering the three pillars that should drive value we can state that:

- **Bond value:** (GDP, inflation) + *Narratives* [(LT GDP, inflation]].
- **Equity value:** (GDP, inflation) + *Narratives* [(LT earnings, Δ Price earnings)]

The above definitions of value help define the equilibrium levels for a given regime, which means that, for an investor, there are two potential signals from value indicators:

1. **Deviation from equilibrium *within* a regime, leading to mean reversion towards equilibrium within the regime.** Among the two utility functions of value mentioned before – store of value and store of future capital gains – the latter is dominant here.
2. **Change in equilibrium itself**, i.e., **regime shift**, where protecting value as a store of value (defensive) is important.

Regarding the second one- the change in equilibrium- the dynamic nature of narratives adds a dynamic feature in the value assessment beyond the traditional static approach and helps define if we are approaching a potential regime shift. **Looking at the current environment, we see that the first and the third narratives (growth and inflation trade off and the monetary narrative) are interconnected and advancing and they both push towards an increase in inflation and more interconnected fiscal and monetary policy.** This, we believe, will likely be the key feature of the new regime after Covid-19.

Here are the main conclusions we can draw when looking at all the indicators of asset class value.

Table 2. Summary of relative and absolute value in equities and bonds

Asset Class	Relative Valuation ST	Absolute Valuation LT
Equities, Bonds	Attractive versus bonds	Expensive (higher rates may most likely hit equities)
	Expensive versus equities	Expensive

Source: Amundi. Colours (red for expensive, green for attractive). Data as of 8 February 2021.

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"Equities and bonds are expensive over the long term, while in the short term equities are attractive versus bonds."

First, we have a cyclical tactical equity relative to bond 'value' indicator: pointing at **equities' attractiveness versus bonds on a short-term horizon.** Yet, this does not say much about absolute performances for either equities or bonds and does not mean that equities cannot do well in absolute terms in the short term (1 to 2 years horizon). Over the medium/long-term, as poor bond value unfolds as a consequence of higher rates and since the cyclical equity versus bond indicators cannot say much about medium/long-term trends, higher rates will most likely hit equities.

Combining absolute bond and equity valuations, we see that both point **to some expensiveness in the sense of levels in excess of what would be implied by long-term real fundamentals alone.** This is due to the long-term monetary factor and long-term narratives. The time horizon is different: bond expensiveness is hit by higher rates, an outcome that also affects equity valuations, hitting equity markets.

This means that in our view the only value left in the market TODAY is relative value.

The regime shift towards the road back to the 70s

With a longer-term perspective, the monetary factor distorts the absolute-value sets of indicators (for bonds and equities). The narratives also point in this direction as the third narrative, the monetary one, dominates the first one in the sense that an extreme monetary stance will also help to push towards the road back to the 70s. In equities, the dominance of central banks is distorting absolute valuations as well. This means that when looking at the long term, the most likely evolution will be the one relating to the third narrative of central banks moving from a low (and lower) interest rate environment, with low inflationary expectations, low forever, into new unconventional policies designed explicitly to restore inflation and account for overall inflation (real, but also related to financial assets).

"When looking at past changes of regime, central bank actions and inflation expectations have always played a pivotal role in determining a change of regime."

In fact, **when looking at past changes of regime, central bank actions and inflation expectations have always played a pivotal role in determining a change of regime.**

At any point in time, within a regime (and this contributes to defining it), there is a certain preference for a certain stability of prices. In the 70s, there was a certain preference for inflation in the prices of goods and services, until this became extreme and determined a reversal of preference towards inflation control. Consequently, in the following regime there was an explicit dislike for this sort of inflation and an implicit (at least) predilection for asset price inflation. Disinflation and then deflation came as no surprise as the essence of the past regime and are now leading to a change of preferences again.

Today, in the transition phase towards a different regime, for the first time in more than three decades narratives are explicitly expressing a preference for inflation.

"Today, in the transition phase towards a different regime, for the first time in more than three decades narratives are explicitly expressing a preference for inflation."

Inflation has ceased to have a negative connotation and is now a desire and it will be most likely the way out of the current crisis. In a world where debt is rising to finance the extreme fiscal push needed to exit the economic crisis led by the pandemic, inflation can be a win/win for central banks and states. After a prolonged period of low inflation and deflation worries, some inflation is welcome by central banks.

Higher real asset inflation will likely also help reabsorb excessive financial asset inflation, and possibly reduce inequalities (coupled with appropriate policies). Finally, inflation will help also manage the debt burden. Inflation higher than growth will help stabilise and reduce debt-to-GDP ratios and, therefore, it would be a welcome outcome for states with high debt levels.

When a preference across society and its institutions is being established, experience shows that the prevalent narrative becomes self-fulfilling and this often leads to a new mandate given to central banks.

"In the road back to the 70s, investors will have to revisit their portfolio construction approach. Equities will be key, but inflation surprises will challenge the most expensive growth areas. Value should therefore be favoured."

The transition phases, unsurprisingly, see the coexistence of previous and new mandates.

Considering this possible narrative outcome, investors should make themselves ready for a process of rebalancing risk premia.

Equities will be key both in tactical (preference versus bond) and strategic asset allocation. In fact, despite their stretched absolute valuations they are the "must own" assets from a strategic long-term viewpoint. This is mainly because in a world of lower expected returns (due to the lack of returns on the bond side), investors will have no choice, but to increase equity allocation. As adding risk is not a panacea, it is crucial that investors manage tactically the risk rotations, while preparing portfolios for the consequences of a regime shift.

"Investors should consider inflation protection strategists to hedge against rising inflation."

Value should be favoured compared to expensive growth areas that would be more vulnerable in case of inflation surprises.

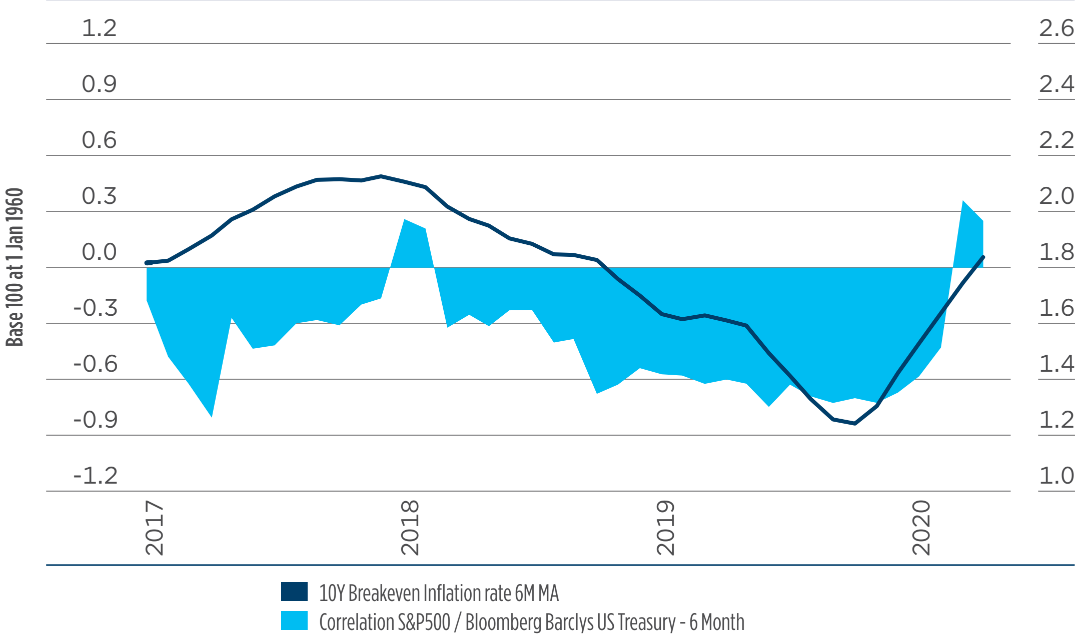
Flexibility will also be paramount, especially in fixed income where traditional benchmarks with long duration might see negative returns with rising rates.

Hence, investors should look for **inflation protection strategies and flexible duration management approaching this regime shift.**

"Embracing a flexible approach to bonds and enhancing diversification with absolute return strategies and real assets will be paramount as traditional equity/bond negative correlation might revert."

In a rising inflation environment, traditional bond/equity negative correlation might also be challenged. Finally, investors should seek to enhance diversification into assets that would be more resilient to higher inflation. In this respect, **real assets (such as real estate infrastructure) and absolute return strategies will be helpful tools.**

Figure 11. Bond/equity correlation turns positive with rising inflation expectations



Source: Amundi, Bloomberg. Data as of 31 January 2021.

Key take-aways for investors

1

Higher inflation challenges traditional diversification, as correlation between equity and bonds turns positive. To build an inflation-proof portfolio, investors should consider increasing their allocation to pockets of assets such as inflation-linked bonds, real assets (real estate and infrastructure in particular) and commodities.

2

In a world of stretched absolute equity and bond valuations, relative value is the only value left in markets. Investors should look at relative value "within" and "across" asset classes. Absolute return approaches that seek to extract relative value in markets, with limited directional risk, could enhance diversification.

3

The role of equities will be key both in tactical (attractive valuations vs bond) and strategic asset allocation. Despite their stretched absolute valuations they are the "must own" assets, in a world of lower expected returns (due to the lack of returns on the bond side). Investors will have no choice, but to increase equity allocation.

4

A higher inflationary regime will drive a multi-year rotation from growth to value stocks. Lower interest rates, used to discount future profits, have amplified growth outperformance and therefore growth stocks are now vulnerable to higher rates. Investors should focus on sector allocation with a preference for sectors linked to real assets (commodities, energy and infrastructure).

"This is not the time to give up on valuation, but instead stick to value in search of opportunities while carefully following the evolution of market narratives. Be prepared, as this is the time to play opportunities in the market."

Source: Amundi, as at 15 February 2021.

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Important Information

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