

CENTRAL & ALTERNATIVE SCENARIOS (12 TO 18 MONTHS HORIZON)

Monthly update

On the back of our quarterly updates, we have reviewed the narrative and the probabilities of our central and alternative scenarios. In our central scenario, the policy mix and improving fundamentals support the recovery and markets. Beyond 18 months, we expect US growth to revert to potential amid a higher inflation regime, while stagflationary pressures rise, in particular across Europe. As valuations are stretched and economic momentum is fading, the expected risk-adjusted return of equities is diminishing. We now consider vaccine-resistant virus variants or vaccination-related issues as a risk to the central scenario.

DOWNSIDE SCENARIO 25%	CENTRAL SCENARIO 60%	UPSIDE SCENARIO 15%
Slumpflation	Multi-speed recovery	Sustainable & inclusive recovery
Analysis	Analysis	Analysis
<ul style="list-style-type: none"> ✿ Recovery undermined by pandemic-related constraints, despite successful vaccination campaigns ✦ Growth in Advanced Economies (AEs) back at (or below) potential, despite fiscal support ✦ Persistent inflationary pressures due to prolonged supply-chain bottlenecks ✦ Faster than expected slowdown in China impacting AEs ▲ Economic and financial fragilities exacerbated by tighter financial conditions ● Falling medium-term growth expectations and higher interest rates undermine public debt sustainability and limit fiscal support ● Protectionism and de-globalisation, affecting trade and value chains ● Stagflationary pressures exacerbated by deleveraging and bottlenecks 	<ul style="list-style-type: none"> ✿ Strong but uneven multi-speed recovery in 2022 followed by a slowdown in 2023 ● Supportive policy mix allowing debt to GDP ratios to stabilise ● AEs monetary policies to normalise gradually starting with the Fed ✦ Narrower growth premium gap between EMs and AEs (US policy boosters and China’s deceleration) ✦ US growth and inflation peaked in Q2 and then normalise; EZ growth and inflation to peak in H2 ▲ NGEU execution is diluted, despite political commitment ● Lower solvency risk thanks to positive corporate earnings momentum, active deleveraging and low funding costs ✦ Income and wealth inequalities increase social and political tensions 	<ul style="list-style-type: none"> ✿ Mass vaccinations enables a full global recovery ✦ Closing gap between manufacturing and service sectors ✦ Consumption strength driven by savings and increased disposable income ▲ The Fed stays on hold despite the US job market recovery and wage pressures ▲ NGEU implementation is a success ● Virtuous circle of growth and inflation without global overheating ✦ Inclusive and sustainable recovery ● Higher potential growth thanks to productivity gains driven by digital and green developments
Market implications	Market implications	Market implications
<ul style="list-style-type: none"> – Favour cash, USD and US Treasuries – Play minimum-volatility strategies – Gold 	<ul style="list-style-type: none"> – Lower risk-adjusted expected returns due to high valuations and decelerating growth – Contained steepening of US Treasuries yield curve spills over into EZ and EM. – Favour equity value and cyclicals – Inflation hedge via gold, linkers and equities – Favour barbell positioning in the currencies space – EM: Short-term caution, long-term income and growth story intact 	<ul style="list-style-type: none"> – US Treasuries curves bear steepen – Favour risky assets with cyclical and value exposure – Favour linkers as an inflation hedge

TOP RISKS

Monthly update

This month, we are raising the probabilities of Economic and (Geo)political risks to 20%. We now consider Covid-19-related risks, including variants and vaccine issues, as part of the economic risks to our central scenario. Risks are clustered to ease the detection of hedging strategies, but they are obviously linked.

ECONOMIC RISK
20%



- **4th wave of Covid-19**
 - Despite mass vaccinations, a new wave kicks in after the summer holiday in the northern hemisphere
 - New lockdowns and restrictions derail the recovery
- **Pandemic 2.0**
 - One or several virus variants that would make existing vaccines ineffective OR
 - unexpected logistics issues or side-effects of the vaccines could undermine the economic recovery
- **Global tapering**
 - As inflation expectations rise, the Fed and other DM central banks could reduce their asset purchase programs earlier than expected and stop or slow the recovery
 - Central banks' reaction function, premature exit or miscommunication could be sources of uncertainty
- **A protracted recovery with multiple relapses** might hit business and consumer confidence, looping in sectors that have not yet been directly hit by the pandemic, such as financials

FINANCIAL RISK
20%

- **De-anchoring inflation expectations** leading to a bond market dislocation as an outcome of policy mistakes, such as pre-emptive monetary policy tightening or oversized fiscal plans
- **Corporate solvency risk:** despite improving fundamentals, the magnitude of the recession could increase solvency risks once central bank liquidity and government guarantee schemes are withdrawn
- **Sovereign debt crisis**
 - With public debt as a share of GDP reaching historically high levels in peacetime, most countries are vulnerable to rating downgrades and rising interest rates, in the event of policy errors
 - Emerging market weaknesses (single-commodity exporters, tourism) could also face a balance-of-payments crisis and increased default risks
- **USD instability, which could impact in both directions:**
 - **(1) depreciation** could push the Fed to stop its APP and negatively impact the Treasuries market, bring deflation into the EZ and Japan, and undermine the EM recovery;
 - **(2) appreciation** could hurt EM countries, with higher UST yields spilling over into the Eurozone bond market

(GEO)POLITICAL RISK
20%

- **US & Europe vs. China cold war**
 - US takes a hard line with China
 - Several sanctions and delistings of Chinese companies are signs of escalation
 - European countries could follow the US, despite their economic interests
 - Possible accidental confrontations in the South China Sea or the Taiwan Strait
- **European populist vote** in Germany, France or Italy could lead to a further fragmentation of the EU
- **EM political instability driven by:**
 - Chaotic virus crisis management and debt solvency measure
 - Higher food prices leading to a wave of unrest similar to the Arab Spring
- **Cyber-attack or data compromise**, disrupting IT systems (security, energy and health services)
- **Underestimated hysteresis effects in DM labour markets**, with rising unemployment, could generate social tensions

 **Cash, linkers, JPY, Gold, USD, Defensives vs. Cyclical**
 **CHF, JPY, Gold, CDS, optionality, Min Vol**
 **DM Govies, cash, gold, linkers, USD, volatility, quality**
 **Oil, risky assets, AUD CAD or NZD, EM local CCY exporters**
 **Oil, risky assets, frontier markets and EMs**
 **Oil, risky assets, EMBI**

CROSS ASSET DISPATCH: Detecting markets turning points

How to the read turning point assessment

- Not reached yet too early to call it
- Approaching to the turnaround
- Turnaround happened

ECONOMIC BACKDROP

- Economic activity strengthened in the eurozone as Covid-19 restrictions were eased, as confirmed by both high frequency data and the latest PMIs. Soft data confirm the optimism underlying the ongoing reopening, delivering strong upside surprises. In particular, upticks in retail and commercial activities confirmed the ongoing bottoming out of the sectors hit hardest by the pandemic. The consensus upward trajectory continues, with steeper trends in France and Italy.
- Economic activity in the US continues to grow at a sustained rate. Surveys remain supportive confirming the strong confidence underlying the reopening of the US economy. However, the CESI Index reversed downward underlain by moderating soft and hard data surprises, while the consensus remains overall stable.

FUNDAMENTALS & VALUATION

- Most equities have reached all-time highs and although the recovery in profits remains solid, valuations look expensive from different angles.
- CB liquidity injection is still the only argument for the markets' high levels, although these contributions are expected to vanish going forward.
- Absolute PE levels are above historical trends and are a sign of investor complacency.



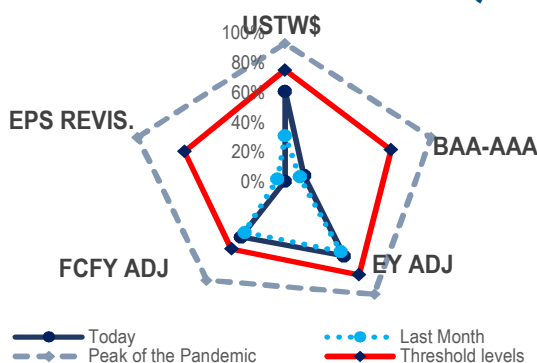
TECHNICALS

- There were no big shifts in contributions with respect to last month from our technical toolbox.
- Markets took the Fed's comments as hawkish, but the turbulence only lasted for few days before equity prices continued to move higher. This was not enough to structure stable "momentum" across the board and may be too quick for contrarian buy signals to last.
- RSIs were in overbought territory prior to the FOMC's June meeting, but turned the other way following the hawkish comments and moved back higher once waters calmed down. Technicals remain mixed with a lack of directional bias at the time of writing.

SENTIMENT

- The Fed changed its dot plot, which now points to two rate hikes in 2023. A hawkish communication relative to the market's expectations explains the sharp correction of risky assets in the aftermath of the event.
- However, volatility rose only slightly and there was no evidence of material deterioration in systemic risk sentiment in our framework.
- Financial conditions deteriorated modestly, with GEM FCIs being hurt the most. This was primarily due to the rebound in the USD, albeit with evidence from CAST offset by the still healthy EPS revisions and a Credit Risk Premium that remains well under control (Moody's belows 65 bps at the time of writing).
- Institutional investors' risk appetite (still pro-risk within the cross-asset spectrum) seems to confirm this but needs to be constantly monitored, given that most of the metrics seem stretched (though well-oriented) compared to historical standards.

Cross Asset Sentinels Thresholds (CAST) still supportive



Source: Amundi Research, Data as of 18 June 2021

CAST flags extremely low risk perception.

Sentinels remain in pro-risk territory due to a general improvement in all its components (except ERP adjusted for credit risk).

Methodology We consider five inputs which we call "Sentinels": USTW\$, Moody's Baa-Aaa, EPS revisions, Earning Yield risk adjusted and Cash Flow yield risk adjusted. These sentinels are used to reposition our tactical asset allocation. Once sound thresholds are detected, the five variables are aggregated as an indicator that anticipates the market's stress conditions, with a certain level of conviction. The pentagon visualizes the five sentinels where the red line represents the alert threshold. The greater the distance above the red line, the higher the risk perception, and eventually the need to move closer to a defensive asset allocation.

GLOBAL RESEARCH CLIPS

1 DM: growth and inflation revised up on US and Eurozone

- Q1 GDP data surprised on the upside and so our forecasts have been revised accordingly.
- We are projecting 2021 US GDP at 7.4% (from 7.2%), 2022 at 4%, and 2021 Eurozone GDP at 4.4% (from 3.3%); 2022 at 3.6%.
- We also revised up inflation on stronger than expected monthly readings.
- For Central Banks we expect:
 - The Fed to start tapering at the beginning of 2022 and the rate lift-off to begin at the end of 2023.
 - The ECB to continue to provide stimulus through 2022 (details to come at the September meeting), either extending the PEPP/current APP or tapering/ending the PEPP while increasing the APP.

Investment consequences:

- 12M core govies targets updated: US 10Y at 2.10/2.30% (from 1.8/2%) – Germany 10Y at -0.10/+0.10% (from -0.20/0.00%) – UK 10Y at 1.10/1.30% (from 0.90/1.10%).

2 USD: short-term rates keep the greenback under pressure

- The cost of hedging dollars has been declining due to front end rates remaining flat as a consequence of the FED's commitment to FAIT (i.e. very dovish stance on the timing of the first lift-off).

Investment consequences:

- Even with the FED staying dovish, the strong growth outlook in the US sets the bar higher for further downside risks on the currency.
- We therefore expect USD to strengthen and are projecting EUR/USD at 1.16 in Q1 2022.

3 Commodities super cycle

- The current shortage in inventories for base metals is not new, as weaker demand due to sluggish growth over the past several years has been halting several new projects.
- Oil production remains well below pre-Covid levels and is expected to resume once issues related to Iran sanctions are resolved.

Investment consequences:

- The recent oil shortage should ease by year-end (12M target: \$65 on WTI), as should the base metals inventory shortage.

4 China growth and RMB depreciation

- The economic recovery is expected to continue at a strong pace: GDP at 8.9-9.5% in 2021.
- The CPI should continue strengthening to 1-2% yoy, while the PPI is likely to peak in May at c.8% yoy.
- The PBoC's RRR increase and approval for outbound investments are an attempt to ease RMB appreciation.

Investment consequences:

- A slight RMB depreciation is ahead as a consequence of the PBoC's efforts to contain currency strength and due to expectations for a stronger USD.
- Target: USD/CNY at 6.5/6.6 for Q4 2021/Q2 2022.

Covid-19 situation update

by Pierre BLANCHET, *Head of Investment Intelligence*

Despite a successful vaccination campaign, the UK recorded 35k new cases of the Delta variant last week (+46% WoW). This has become the most dominant variant, with 90% of new cases. The British PM may have to postpone the final lifting of social restrictions. In Portugal, the situation is deteriorating rapidly, as well, and the number of new cases is rising in Brazil and Russia. The severity of the Delta variant is unclear, but it is estimated to be 60% more transmissible than the "British" variant. Projections show the Delta variant could account for 90% of all Covid-19 cases by the end of August and could potentially trigger another wave in the northern atmosphere after the summer holiday.

At the time of writing nearly a quarter of the world population has received at least one dose of a Covid-19 vaccine but less than 1% in poorer countries. More than 3.0 billion doses have been administered globally. With a daily run rate of more than 40 million doses administered each day, it will take from six to nine months (at least) to be close to herd immunity. We still consider one of the key risks to be that one of one or more of the virus variants would make existing vaccines ineffective and/or that the vaccines could generate unexpected side effects.

AMUNDI ASSET CLASS VIEWS

	Asset Class	View	1M change	Rationale
EQUITY PLATFORM	US	=		President Biden’s spending plans, coupled with continued vaccinations and reopenings, should support consumer spending in goods as well services sectors. However, government payments ending in some states, potential tax hikes and inflation resulting from supply shortages could act as a dampener. In this environment, we remain selective and look for companies that have the pricing power to pass on the increase in input prices to consumers to preserve margins.
	US value	+		We remain constructive on value (particularly high quality), cyclical stocks and realise that as economic data comes more in line with forecasts, the onus of outperformance shifts from market selection (beta) to security selection. These rotations will remain a long-term trend, supported by rising inflation, a mild increase in bond yields and strong economic growth.
	US growth	-		We remain defensive on hyper growth/speculative growth segments which are already moving away from the excessive exuberance displayed earlier. As interest rate and inflation expectations increase further, this trend may continue.
	Europe	=		Strong economic growth and accommodative policy (ECB and Next Gen EU plan) supports our view of a cyclical recovery that should benefit the region. However, lot of the good news is priced into the markets already and we prefer to focus on relative value and to be selective amid inflation pressures that could potentially affect margins for some companies. Interestingly, ESG, investor activism and minority shareholder rights remain key themes in the markets and for us.
	Japan	=		Relative earnings trend suffered recently due to strong earnings in the US and Europe but, in the long term, global cyclical recovery and prospects of a weakening yen should be supportive for Japanese markets.
	Emerging markets	=/+		The region is displaying a revival of growth and earnings, and attractive valuations, but the need to be selective and focus on value/cyclical areas is high. We see some headwinds from geopolitical risks and the speed of increase in US rates and inflation.
FIXED INCOME PLATFORM	US govies	-		We are cautious towards USTs in light of our view of persistent inflation, an environment of rising yields and massive fiscal deficit. Markets seems to have bought the Fed’s narrative of temporary inflation that prevented any hike in yields for the time being but we believe the general direction of rates would be upwards (non-linear). This will be negative for duration. We prefer Treasury inflation-protected securities.
	US IG corporate	=		Investors should limit duration times spread (beta) and long-duration risk in portfolios as an increase in core yields going forward could affect credit prices. However, we like short-duration debt and prefer idiosyncratic opportunities to add value. In securitised credit, we are valuation-conscious as we think most of the sector has recovered.
	US HY corporate	=		Carry in HY remains attractive amid improving economy and fundamentals, and the opportunity to refinance debt at low yields. However, we remain very selective so as to balance quality with the potential for higher returns.
	European govies	-/=		We stay cautious on core Euro bonds as we believe that an improving economy (in light of the Next Gen EU plan), reopenings and inflation pressures could result in an upward move in yields. However, we acknowledge the continued conviction of ECB to maintain policy support and easy financial conditions that should prevent any quick increase in yields. This ECB support would also help the region avoid fragmentation, thereby supporting Euro peripheral debt.
	Euro IG corporate	=/+		We keep our beta stable but do so through high-quality names and are encouraged by ECB support, which provides a strong technical backdrop, especially in light of improving fundamentals. We prefer BBBs and short duration debt and cyclical sectors such as financials (subordinated debt) energy and auto. However, we think investors should rebalance away from senior financial debt.
	Euro HY corporate	=		Earnings recovery, deleveraging and debt refinancing at low yields are all factors that allow us to explore low-rated names but we maintain a balance among quality, yield and liquidity. We avoid names where an increase in core yield could affect prices substantially.
	EM bonds HC	=/+		We are slightly constructive on HC in the short term but acknowledge that there is very limited scope for spread compression in the medium term. We maintain our preference for HY over IG in corporate as well sovereign space as HY offers higher carry and could benefit from reflationary dynamics, but selection remains crucial.
	EM bonds LC	=		We are particularly cautious on rates but in FX we favour higher carry stories while being mindful of liquidity. We have a more positive view for the second half of the year despite expectations of USD getting stronger, but remain selective.
OTHER	Commodities			Economic recovery is positive for commodity prices in general. But it should be noted that current supply shortages of base metals are a result of stoppages in projects over the past few years due to sluggish demand in the past. These are more pronounced in commodities (copper) linked with the green transition. However, by year-end this should ease. Similarly oil supply should ease when issues related to Iran sanctions are resolved. We maintain our 12-month target of \$65/b for WTI.
	Currencies			Monetary tightening and fiscal loosening should support USD (rates and economic growth advantage). We expect a stronger dollar – our EUR/USD target for year end is 1.17 and by Q1 2022 is 1.16. When real rates rise (remaining negative though) and inflation expectations move lower, the USD should strengthen against both low and high yielding FXs.

LEGEND



Source: Amundi, as of 22 May 2021, views relative to a EUR-based investor. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research, investment advice or a recommendation regarding any fund or any security in particular. This information is strictly for illustrative and educational purposes and is subject to change. This information does not represent the actual current, past or future asset allocation or portfolio of any Amundi product.

IG = investment grade corporate bonds. HY = high yield corporate; EM bonds HC/LC = EM bonds hard currency/local currency. WTI = West Texas Intermediate. QE = quantitative easing.

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