CENTRAL & ALTERNATIVE SCENARIOS (12 TO 18 MONTHS HORIZON)

Monthly update

We maintain the probabilities of our scenarios unchanged. Some of the risk factors we identify may occur in our central scenario, which is probably not yet fully priced-in by markets. Risks remain skewed to the downside in the short term, but it would take a combination of several risk factors to trigger the downside scenario at the 12-18 month horizon. At this horizon, we believe that the downside is counterbalanced by an upside scenario, that of a rapid decline in inflation due to an easing of gas prices, a ceasefire in Ukraine, and/or to the combined tightening of global monetary policies, the impact of which can be underestimated.

DOWNSIDE SCENARIO 15%

Deep global slump

Analysis

- Worsening/expanding **war in Ukraine.**
- Energy crisis and **deep recession in Europe.**
- **Covid-19 resurgence.**
- **De-anchoring of inflation expectations,** CB lose control.
- **Recession in China.**
- **Global economic downturn** with, in a second stage, renewed deflationary pressures.
- **Global financial crisis/debt crisis with several EM defaults.**
- **Governments can no longer implement countercyclical fiscal policies.** Decisive action on financial repression.
- **Climate transition measures postponed.**

Market implications

- Favour cash, USD and US Treasuries.
- Play minimum-volatility strategies.
- Gold.

CENTRAL SCENARIO 70%

A stagflationary episode, with rising divergences

Analysis

- **Stalemate in the Ukraine war.** We expect a ceasefire at some point in 2023; in the meantime the situation may deteriorate further.
- **Confidence shock in EU,** due to high energy prices.
- **Covid-19** is an endemic disease.
- **Inflation fails** to return to CB target by 2024.
- Global **nominal GDP to trend higher,** mitigating the impact on earnings.
- **Growth divergences:** recession in the Eurozone and in the United Kingdom, sluggish rebound in China, sub-par growth in the United States (far below potential in 2023).
- **CB divergences:** Fed to continue its tightening cycle, but adopting a less hawkish stance (end of Q4); ECB to raise rates, adopt a passive QT and activate the TPI; PBoC on easing bias.
- **Divergent fiscal policies:** accommodative in the EU, restrictive in the United States in 2022, but more neutral 2023-24.
- **Climate change** disrupts the commodity cycle and adds to stagflationary trends.

Market implications

- Lower risk-adjusted real returns expected.
- Contained steepening of US Treasury yield curve, as well as Eurozone and EM.
- Inflation hedge via gold, linkers, equities, real assets and commodities.
- EM: short-term caution, long-term real income and growth story intact.

UPSIDE SCENARIO 15%

Inflation falls back quickly, ending the stagflationary episode

Analysis

- **Ceasefire in Ukraine paving the way for peace talks.**
- **Russia partially resumes gas exports to Europe,** commodity market normalises.
- **Covid-19** recedes.
- **Inflation falls back quickly,** supply bottlenecks ease.
- **Global recession fears** dissipate and inflation gradually returns to more normal levels, easing pressure on CB.
- **Lower uncertainty,** extra savings and renewed purchasing power can fuel consumption and investment in DM without erosion of corporate margins.
- **Fiscal discipline** gradually restored. In Europe, a new plan (common debt) is put in place to address the changing energy mix.
- **Climate change** policies and energy transitions become first priority.

Market implications

- US Treasury curve to bear steepen.
- Favour risky assets with cyclical and value exposure.
- USD depreciation.
- Favour linkers and equities as an inflation hedge.

Geopolitic · *Covid-19 related topics* · *Growth and inflation expectations* · *Monetary and fiscal policy* · *Recovery plans or financial conditions* · *Solvency of private and public issuers* · *Economic or financial regime* · *Social or climate related topics*

TOP RISKS

Monthly update

We keep the probabilities unchanged for the three families of risks. We see risks growing on all fronts, closely linked to each other. Economic fundamentals are deteriorating globally, which is reflected in the central scenario. The course of the Ukraine war and its potential implications can tip the scenario in either direction, but risks are tilted to the downside in the short term. We consider Covid-19-related risks (including lockdowns in China) as part of the economic risks. Risks are clustered to ease the detection of hedging strategies, but they are obviously related.

ECONOMIC RISK 30%

— **Global recession** driven by an oil/gas shock, a tightening of monetary conditions, and a loss of purchasing power.

— **The *weaponisation* of gas supply** by Russians could cause a **severe energy crisis in Europe,** leading to a **deep recession** (confidence shock).

— **Economic crisis in Eastern Europe** following a collapse of the Russian economy, elevated energy prices, uncontrolled inflation, and a migrant crisis.

— **Disordered CB adjustments**, which underestimate supply-driven inflation and lose control.

— **Global profit recession** triggered by the global slowdown, coupled with persistent input-cost pressures (margin compression).

— **Recession in China.** Zero Covid-19 policy combined with a housing crisis spiralling out of control.

— **End of the great coincidence:** with the persistence of stagflationary pressure, CB and governments' goals are no longer fully aligned: the room for countercyclical fiscal policies is reduced.

— **Pandemic:**

- Risk of a more dangerous and vaccine-resistant variant.
- New lockdowns or mobility restrictions.

— **Climate change**-related natural events hurt growth visibility and social balance.

+ Cash, linkers, JPY, Gold, USD, Quality vs. Growth, Defensive vs. Cyclicals.

- Risky assets, AUD CAD and NZD, EM local CCY.

FINANCIAL RISK 30%

— **Sovereign debt crisis:**

- An extended war in Ukraine would hurt DM vulnerable public finances with public debt ratios already at historic highs.
- De-anchoring inflation expectations could lead to harsher monetary tightening and to a bond market dislocation.
- Most countries are vulnerable to rating downgrades and rising interest rates.
- Weak EM could face a balance-of-payment crisis and increased default risks.

— **Corporate solvency risk increases,** amid deteriorating fundamentals, rising uncertainty, and corporate margins under pressure (high input cost, double orders lead to profit warnings).

— **Widespread greenwashing and ESG investment bubble undermine the energy transition funding.**

— **USD overshooting** leads to unstable currency markets.

— **Currency wars:** currency appreciation is a way for CBs to fight inflationary pressures.

+ CHF, JPY, Gold, CDS, optionality, Min Vol.

- Oil, risky assets, frontier markets and EMs.

(GEO)POLITICAL RISK 30%

— **Ukraine war:**

- **Risks are titled to the downside.** There is a **60% likelihood** of a negative development of the war, including a **25% likelihood of direct confrontation with the West.** This risk grows the more Russia faces military defeats.
- Despite our expectation for the conflict to worsen in the meantime, **our base case is an end to hostilities 2023** (most likely H2) at **35%** likelihood.

— Following mid-term election, **the United States will focus on domestic political battles, which will heighten tensions with China,** as Republicans and Democrats compete for hawkishness, **contributing to growing the 'Taiwan' risk in 2023.**

— **EM political instability driven** by higher food and energy prices, leading to a wave of social unrest.

— Iran or Korea **nuclear programmes** renewed concerns and sanctions.

— **Cyber-attack or data compromise,** disrupting IT systems in security, energy, and health services is elevated as Russia seeks to undermine Western support to Ukraine.

+ DM Govies, Cash, Gold, USD, Volatility, Defensive, Oil.

- Credit and equity, EMBI.

CROSS ASSET DISPATCH: detecting markets turning points

The turning point has occurred | Approaching the turning point | Not reached yet too early to call it

ECONOMIC BACKDROP

- Economic momentum is slowing amid persistently high inflationary pressures and weakening domestic demand. The US economic outlook is deteriorating on the back of progressively tighter financial conditions and recession risks remain prominent for mid-2023. On the European front, we expect a cost-of-living and inflation-driven recession during the upcoming winter season, which we now expect to be deeper than previously expected and followed by a shallow recovery.
- The prolonged stress on the geopolitical front and the tug of war between fiscal and monetary policy make the final economic outcome uncertain, exacerbating data volatility.

FUNDAMENTALS & VALUATION

- Despite some correction in October and apparently decent valuations, it is still difficult to see strong catalysts for entry points.
- Stock multiples look aligned with the current inflationary environment and tight monetary policy, but are not discounting yet any recession risk. In relative value, considering high rates, they are not in favour of risky assets.
- Fundamentals have been worsening further, paving the way for a profit recession scenario.

NEUTRAL + ASSET ALLOCATION

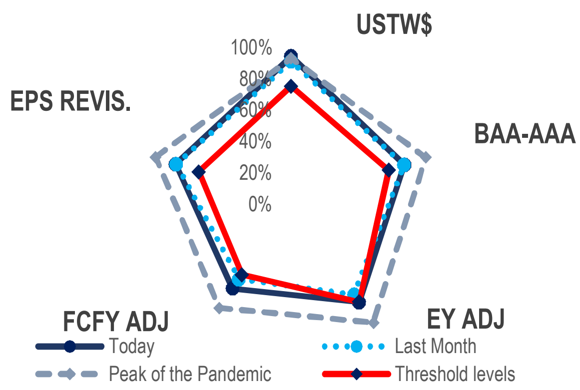
TECHNICALS

- Technicals remain highly volatile in the current market set up. We entered October with risky assets showing fragmented trends, but at the same time being oversold, highlighting the risk of short squeeze in most markets. At present, trends have stabilised and contrarian metrics, while still far from sell signals, have recovered substantially, thus limiting investors' appetite. The picture remains mixed, with technicals failing to show some clear directionality.

SENTIMENT

- Rising financial instability across the globe (BoE and Japan's MoF FX interventions) highlighted downside risks to the central banks ability to keep tightening policy at the same pace. Risky assets enjoyed a relief rally, but risk sentiment metrics failed to support the move. Financial conditions remain tight in all regions, while the USD, credit risk premium, and risk concentration keep fuelling into higher risk-off probability in our CAST and MoMo models, respectively.

Cross Asset Sentinels Thresholds (CAST) – Stay defensive, most sentinels are breaching alerts.



Source: Amundi Institute. Data as of 25 October 2022.

The CAST risk perception failed to show a structural increase in Q1, but has turned less favourable since Q2 and it's not reverting yet EPS revisions have turned negative in response to recession fears and the USD keeps reminding liquidity risks. Credit risk premium remains high and above alert, maintaining the preference for defensive assets.

Methodology: we consider five input variables, called 'sentinels': US trade-weighted dollar, Moody's Baa-Aaa spread, EPS revisions, adjusted earning yield risk, and adjusted cash flow yield risk. 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 any market stress conditions, with a certain level of conviction. The pentagon visualises the five sentinels, where the red line represents the alert threshold. The greater the distance above the red line, the greater the risk perception, and eventually the need to move closer to a defensive asset allocation.

AMUNDI INSTITUTE CLIPS

1 Quantitative tightening prospects for the main central banks

- The Fed is unlikely to accelerate its pace of quantitative tightening (QT) over the next few months; rather, it will be focusing on keeping policy rates in restrictive territory for a prolonged period of time.
- For the ECB, we believe a reduction in the size of its asset purchase programme is unlikely; instead, we expect TLTRO repayments and redemptions to drive passive QT over the next quarters.
- Uncertainty is high on the BoE's £40bn QT plan, as it will hinge critically on fiscal policy developments.

Investment consequences

- Equity: stay UW.
- Core rates: slight UW/neutral on duration, with rising real yields and the US curve flattening.
- Stay cautious on peripherals.
- Credit: favour IG over HY.

2 US labour market is tight

- We expect the US participation rate to stay lower than its pre-Covid-19 level, as many workers in the 55+ age cohort have left the workforce.
- Since corporates have been experiencing challenges in recruiting skilled workers, now they look more likely to open fewer positions, rather than laying off staff.
- We believe that a structural shift in labour supply and higher labour market frictions may have shifted NAIRU higher, implying that tighter policy is needed to slow the labour market.
- Wage growth has been moderating very mildly.

Investment consequences

- Stay cautious on equity; favour the United States (US) over Europe; on factors, favour Quality, Value, High Dividend, and Min Vol.
- The dollar should strengthen further (EUR/USD cross exchange rate is foreseen at 0.92 and 1.02 in six and twelve months, respectively).

3 Earnings downgrade

- EPS have started experiencing more significant downgrades: 2023 EPS estimates are down 4.2% and 7.6% from their peaks in the US and Europe, respectively.
- The EPS downturn will be mostly driven by margins, as inflation supports top-line and nominal EPS.
- We are using the 1970s and 1980s recessions as a template. Back then, the US peak-to-trough EPS fall was -15% and -19%, respectively. Those EPS downturns lasted 12 and 15 months, respectively.

Investment consequences

- Margins compression, but they remain at high levels, especially in the US.
- Margins are likely to shrink, as the economic downturn accelerates.

4 Lessons from the UK episode: 'tug-o-war' between monetary and fiscal policy

- The UK situation remains unresolved, as the crisis started with a lack of fiscal credibility, sending Gilt volatility to the roof and with spillover into global rates. Hence, the ball is still mostly in the fiscal camp.
- The BoE is in a difficult position, preventing financial instability with temporary supportive measures. It may be forced to extend its support and delay active QT.
- Only a strong political U-turn could help restore some fiscal credibility.

Investment consequences

- UK rates should keep underperforming major countries.
- Short GBP against USD.

5 Private assets

- Rising rates and decelerating economy are weighing on private equity value, as happened during past recessions.

Investment consequences

- Private markets are benefitting from the illiquidity premium, but look expensive and should converge gradually to their fair value.

AMUNDI ASSET CLASS VIEWS

	Asset Class	View	1M change	Rationale
EQUITY PLATFORM	US	=/+		The Fed's monetary policy and corporate earnings are the two main factors that will drive equities in the medium term. While valuations are more attractive than before, the aforementioned factors are not favourable given the Fed is determined to push rate hikes to bring inflation under control (and eventually affect consumption). We continue to look for names showing balance sheet strength, margin resistance and an overlay of quality, value and dividend characteristics.
	US value	+		We are positive on value and prefer names that show quality features, are less cyclical and have the ability to maintain margins. However, we avoid distressed value names where the earnings potential doesn't match the valuation.
	US growth	-		Select growth names have corrected, but growth as a group doesn't present an attractive backdrop in light of rising rates, which that could affect valuations further. We remain cautious and are exploring the quality side of the markets.
	Europe	--		In light of the energy crisis and escalating geopolitical tensions, markets' earnings estimates for 2023 are being revised downwards, but it is likely the impact will also be felt in profit margins. However, companies that can maintain pricing power and strong balance sheets should be able to withstand these pressures and reward shareholders.
	Japan	=		Although low valuations, a weak yen (for exports) and an easing central bank are supportive factors, Japan is a cyclical market that could be affected by the deceleration in global economic growth.
	China	=		China continues to be affected by the government's zero tolerance for Covid and the slowdown in the housing sector. We are monitoring the evolution of its geopolitical relationships with the US and Europe and its fiscal support, which could boost consumer demand. For now, we remain close to neutral, with a possible improving outlook moving into 2023.
	Emerging markets-ex China	=		External vulnerabilities, internal growth momentum and political and geopolitical risks make EM equities a heterogeneous universe. We see deteriorating momentum, particularly in Eastern Europe, where we avoid Hungary and Poland. On the other hand, we like Brazil and the UAE but are cautious on Taiwan and South Korea.
FIXED INCOME PLATFORM	US govies	=		The high inflation prints strengthen the Fed's resolve to hike rates, even at the cost of damaging the economy. While we are neutral on duration at the moment, we remain active and inclined to upgrade our view depending on how far UST yields increase. Real yields (TIPS) have reached their highest levels in more than a decade, making them attractive.
	US IG corporate	=/+		IG spreads are not far from their long-term average, but bond yields are at multi-year highs, even as corporate fundamentals look strong. We are selective and believe investors should consider keeping their portfolio beta stable and balance the need for quality with liquidity and income.
	US HY corporate	-		As the Fed continues its tightening path, we think financing costs could rise for low-rated companies. This, coupled with liquidity constraints and potential cash flow problems from slowing demand, makes us defensive on HY.
	European govies	=		We are close to neutral in core Europe, but retain the flexibility to adjust this stance depending on what narrative is driving the market – economic growth concerns or high inflation (and therefore a hawkish ECB). In the peripheral debt markets, a tightening ECB, with a limitation to avoiding fragmentation in ECB, leads us to be cautious.
	Euro IG corporate	=		We believe that valuations are reasonable but geopolitical tensions persist and economic growth is weakening. On the other hand, company fundamentals are strong but companies are using their cash reserves. We are monitoring cash levels and avoiding segments with high debt. Overall, we keep our neutral stance.
	Euro HY corporate	-		While default rates remain low, a deteriorating economic backdrop could affect cash flows and a hawkish ECB may cause volatility in spreads. Thus we remain cautious, with an eye on liquidity, potential refinancing risks and quality.
	China govies	=/+		The diversification benefits of Chinese debt for global investors make the asset class attractive, along with the limited prospects of any significant monetary tightening in the medium term.
	EM bonds HC	=/+		EM debt is under pressure from the DM tightening cycle, but we see selective opportunities in HC, with a preference for HY over IG. This is true for countries where government finances are improving and external vulnerabilities are limited. We also like commodity exporters such as the UAE and Brazil and are vigilant on other sovereign defaults.
	EM bonds LC	=		We are very selective in LC, favouring countries in which central banks have brought inflation under control and those that provide attractive carry (Brazil). However, EM FX has been hurt by the USD strength, so some stability in US rates is needed for us to see value in the FX and LC bond space.
OTHER	Commodities			Oil prices are likely to remain capped by economic concerns in the short term, but supply-side issues (tight OPEC+ spare capacity, potential EU ban on Russian crude) mean the risks are tilted to the upside. On gold, while rising real rates are not supportive, the metal may act as a good diversifier, particularly if CBs (i.e., the Fed) alter their hawkish views next year.
	Currencies			We believe the USD should strengthen in the near term as high core inflation should lead the Fed to maintain its tightening stance. A dovish pivot from the Fed is the main catalyst that could invert this trend. However, we are negative on the GBP.

LEGEND

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	Negative		Neutral		Positive		Downgrade vs previous month	Upgraded vs previous month

Source: Amundi, as of 27 October 2022, 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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CROSS ASSET
INVESTMENT STRATEGY

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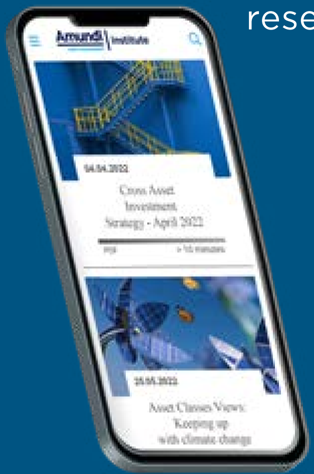

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