TOP RISKS

Monthly update

We see risks on all fronts, but with a little less intensity at the beginning of the year. As such, we lowered the probabilities from 30 to 25%. Economic fundamentals are deteriorating globally, which is reflected in the central scenario, but is not yet fully priced in the equity market. The course of the Ukraine war and its potential implications can tip the scenario in either direction: risks are tilted to the downside in the short term, but the probability of ceasefire by year-end remains significant. We consider Covid-19-related risks as part of the economic risks. Risks are clustered to ease the detection of hedging strategies, but they are related.

ECONOMIC RISK 25%

- **Global recession** driven by an oil/gas shock, tightening 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.
- Central banks continue to raise interest rates, giving priority to the fight against inflation, without worrying about the recession risks. **Global profit recession** triggered by the global slowdown, coupled with persistent input-cost pressures.
- **Recession in China: the new Covid-19 wave of covid is not contained.**
- **End of the great coincidence:** with stagflationary pressure, CB and governments' goals are no longer fully aligned: the room for countercyclical fiscal policies is reduced.
- **Europe: inconsistency in the policy mix (accommodative fiscal stance coupled with restrictive monetary policy)**
- **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 25%

- **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.

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

- Oil, risky assets, frontier markets and EMs.

(GEO)POLITICAL RISK 25%

- **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

Monthly update: The traffic light on technicals has turned from orange to red.

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. Recession risks remain prominent for mid-2023 in the United States, while for Europe we confirm our expectations of a cost-of-living- and inflation-driven recession during the upcoming winter season.
- Inflation has peaked in the United States. We expect a progressive deceleration in both headline and core indices, although signs of greater-than-normal persistence remain. In the Eurozone, inflation may be close to peaking, but is expected to remain near double digits and at stressful levels for some months to come.
- 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

- Stocks look less expensive after the recent pullback, while we do not see any strong catalysts for entry points in the next few weeks.
- Stock multiples look more aligned with the current inflationary environment and tight monetary policy but are not fully pricing in the expected profit recession. In relative terms, considering high rates, fundamentals are not in favour of risky assets.
- Fundamentals deteriorated further; a profit recession is the central case for H1 2023, as well.

NEUTRAL + ASSET ALLOCATION

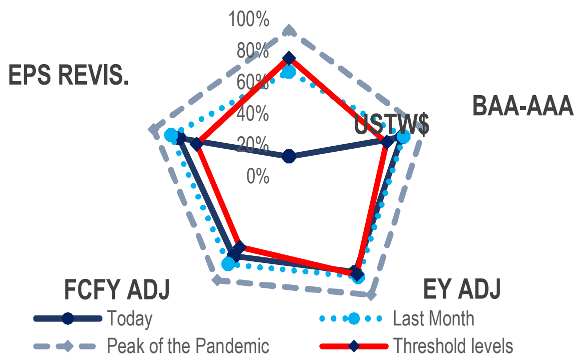
TECHNICALS

- Technicals remain highly volatile in the current market set-up and moved into negative territory in December 2022. Our trend-following indicators do not see value in being long risky assets, as most trends turned fragmented in December.

SENTIMENT

- Lower US inflationary pressures pushed back interest-rate volatility, and financial conditions eased in response to that. Risk sentiment metrics remain fragile. Financial conditions are tight, but eased substantially. The sharp dollar sell-off has been feeding into our CAST model, which now sees a much lower risk-off probability than in November.

Cross Asset Sentinels Thresholds (CAST) – The sell-off in the USD is the strong supportive factor in November. CAST defensiveness is moderating lower.



Source: Amundi Institute. Data as of 16 December 2022.

The CAST risk perception failed to show a structural increase in Q1 but has turned less favourable since Q2. EPS revisions remain negative and the credit risk premium remains high and above alert, yet the move in the USD is calling for a less defensive stance. CAST OFF probability is off its highs and entering a neutral zone.

Methodology: We consider five input variables, called 'sentinels': US trade-weighted dollar, Moody's Baa-Aaa spread, EPS revisions, adjusted earnings 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 Global growth outlook

- The 2023 global GDP forecast was cut to 2.2% from 2.5% YoY. Core inflation should prove sticky across DMs, while EMs have gradually been winning their fight against inflation.
- G3 CBs may be done with jumbo rate hikes, while about 40% of EM CBs have wrapped up their tightening cycle.
- The US soft landing has been confirmed, with very weak growth foreseen in H2 2023 and non-negligible risks of recession. US headline inflation will decelerate markedly in H1. Among core inflation components, core goods will be deflationary, while core services will be the main driver of sticky above-target inflation.
- The Eurozone economy should contract mildly in Q4 2022-Q1 2023. It is too early to call a peak in inflation. Over the next few months, we foresee significant moderation in headline inflation and more gradual moderation in core inflation.
- EM growth has been slowing, despite a possible early reopening in China. As of October, inflation had peaked in some 60% of the emerging universe.

Investment consequences

- The economic backdrop and profit cycle will remain fragile into 2023.
- Amid the correction, cross-asset positioning will remain defensive: UW global equity, OW government bonds, inflation-linked bonds, IG, and gold.

2 Fed outlook

- The Fed is likely to reduce the size of rate hikes, but this does not mean a dovish pivot is likely in the short term.
- The Fed will stay committed to fighting inflation, while past tightening takes a toll on labour market.
- We have cut our 12-month target on 10-year US Treasury yields to 3.5-3.7% from 3.9-4.1%; we expect the US yield curve to bull-steepen in H2 2023.

Investment consequences

- Tactical UW on US duration before moving to neutral stance.
- The Treasury-Bund spread should narrow.

3 Prospects for quantitative tightening in 2023

- The Fed is likely to continue its QT programme in its current form, with monthly caps at $60bn and $35bn on Treasury and MBS run-offs, respectively; the Fed's balance sheet should shrink by some $1tn in 2023.
- Regarding the ECB, QT is likely to be limited to APP securities and to begin in mid-2023. We expect a jump in net supply net of ECB flows.

Investment consequences

- Duration UW on euro rates.
- Peripheral spreads could be under pressure.

4 Recent easing in financial conditions is not justified

- We disagree with the dovish market interpretation of Chair Powell's speech.
- Lending conditions have already been tightening in multiple segments of the US economy; US banks have been tightening lending standards on industrial loans at a pace consistent with a recessive environment.

Investment consequences

- DM bond valuations have become stretched after the rally.
- Markets may have misplaced their hope of a forthcoming Fed dovish pivot.

5 The dollar bull cycle is getting stretched

- The current environment is shifting and a few dollar supports have been fading, as US inflation has been decelerating and the Fed has opened the door to a less aggressive pace of rate hikes.
- The focus could shift sharply from the risk premium over the Fed – which was a strong dollar driver in 2022 – to a dollar premium over fundamentals, as a downside risk.

Investment consequences

- Deeper dollar depreciation in 2023: Six-month EUR/USD target raised to 1.00 from 0.92; 12-month target raised to 1.10 from 1.04.
- We are currently keeping limited dollar exposure (favoured shorts: EUR, GBP and CAD).
- Short USD against JPY and CHF.

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CROSS ASSET
INVESTMENT STRATEGY

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IMPORTANT INFORMATION

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