CENTRAL & ALTERNATIVE SCENARIOS

Monthly update

This month, we maintain the probabilities and narrative of our central and alternative scenarios. We confirm our constructive medium-term view on the “financial recovery regime”, with more caution in the short-term on financial markets, given the virus-dependent news flow.

DOWNSIDE SCENARIO 15%

Secular stagnation

Analysis

- Genetic evolution of the virus drives the pandemic out of control and leads to another negative growth shock, extending the length of the crisis
- Policy mistakes and execution risks of fiscal plans undermine the recovery
- Pause or rollback of accommodative monetary policies, due to internal (asset bubble) or external (FX) constraints
- Protracted economic downturn, due to uncertainty and lack of visibility, affecting business and consumer confidence
- Economic crisis evolves into a financial crisis
- Protectionism and de-globalisation accelerate, negatively affecting trade and global value chains

Market implications

- Favour cash and US Treasuries
- Favour gold, CHF and the yen
- Play minimum volatility strategies

CENTRAL SCENARIO 75%

Multi-year and multi-speed recovery

Analysis

- Multi-year process to get the world economy back on track, with a bumpy road to recovery
- Relapses in economic growth, due to virus outbreaks and lockdown measures until 4Q21
- Massive vaccine rollouts in 1H21 though uneven across regions
- Strong political commitment to mobilise fiscal policies in AEs, but timely execution is a risk
- Accommodative monetary policies continue, in order to cope with deflationary risks and rising public debt
- Positive momentum in corporate earnings and diminishing solvency risks
- Ratio of global trade to global GDP slips further but lower geopolitical tensions after the US elections
- The Covid crisis to exacerbate income and wealth inequalities (risk of increased social tensions)

Market implications

- Contained steepening of US Treasuries yield curve
- Progressive rotation from Credit HY into equities
- Equity thematics are cyclical sectors and are more domestically driven
- Maintain income pockets with EM bond, and credit IG
- Favour gold on pervasive uncertainty, deflation and recession fears

UPSIDE SCENARIO 10%

V-shaped recovery

Analysis

- Health crisis resolved by the end of 1H21, thanks to mass vaccination and efficient lockdown measures
- Sustained “vaccine- enabled” recovery
- Productivity boosts on new digital and green developments
- Faster normalisation of economic activities
- With lower uncertainty, policy boosters feed through to the real economy and financial markets, closing the gap between manufacturing and service sectors
- Sustainable growth and diminishing need for further (fiscal) policy support

Market implications

- US Treasuries curves bear steepening on fast rising growth and inflation expectations
- Favour risky assets with cyclical exposure but can undermine growth stocks
- Favour linkers and gold as an inflation hedge

TOP RISKS

Monthly update

Risks are clustered to ease the detection of hedging strategies, but they are obviously linked. We maintain the overall narrative and change the probabilities of risks in light of the recent developments.

ECONOMIC RISK 20%

- **Covid-19 vaccine rollout issues**
  - Unexpected logistic or side effects issues of the vaccine could have a very negative impact on investors and business sentiment, which has improved significantly since November 2020
  - One or several virus variants that would make existing vaccine ineffective would undermine the expectations of an end soon to the pandemic
- **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
- **Underestimated hysteresis effects in the labour market**, with rising unemployment and uneven impact, could undermine the recovery and generate social tensions
- **A rebirth of inflation and a second "taper tantrum"**
  - The risk is very low in the short run, but upward inflation pressures could build up over time, as the epidemic fades away
  - QE programmes may become problematic when inflation enters the equation
  - Inflation dynamics and central banks reaction function could be sources of uncertainty, in particular in EM, where inflation is close to CBs target
  - Federal Reserve early exit or miscommunication could lead to a second taper tantrum similar to 2013

+ **Cash, linkers, JPY, Gold, USD, Defensives vs. Cyclicals**

- **Oil, risky assets, AUD CAD or NZD, EM local CCY exporters**

FINANCIAL RISK 15%

- **Corporate solvency risk**
  - Prior to the Covid-19 crisis, corporate leverage reached levels above pre-GFC highs
  - The magnitude of the recession has increased solvency risks, regardless of central banks' actions and government guarantee schemes
- **USD significant weakness** could push the Fed to stop its APP and negatively impact the UST market, bring deflation into the EZ and Japan, and undermine the EM recovery
- **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 fragilities (single commodity exporters tourism) could also face a balance of payments crisis and increase default risks

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

- **Oil, risky assets, frontier markets and EM**

(GEO)POLITICAL RISK 10%

- **US/China cold war**
  - Post US elections the hawkish tone from Democrats maintains uncertainties regarding the relationship with China
  - The delisting of Chinese companies might trigger similar retaliation
  - Possible accidental confrontations in the South China Sea or the Taiwan Strait
- **Instability within, and among, EM countries** on the back of chaotic virus crisis management
- **Brexit 2.0**
  - 2020 ended with an exit deal but implementation of it might prove to be a lot more disruptive than anticipated, leading to supply disruptions
  - In the context of a third national lockdown, the domestic political consensus around the Prime Minister might fade as the exit brings an immediate loss of income in several sectors
  - Scotland may ask for another independence referendum

+ **DM Govies, cash, gold, linkers, USD, volatility, quality**

- **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

- The extension of the Covid-19 restrictions across the Euro area keeps weighting on economic activity. Accordingly, both Q4 2020 and Q1 2021 are expected to print a GDP contraction albeit significantly softer than Q2 2020. In the US, after a deceleration in Q4 2020, economic activity is expected to gain momentum, supported by the new fiscal stimulus.
- Soft and hard data confirm these trends, highlighting however remaining divergences across sectors, as manufacturing activities which are less disrupted by the latest restrictions holds up better than services.

FUNDAMENTALS & VALUATION

- Risky assets are trading at high levels, discounting solid growth expectations.
- Equities' absolute P/Es are still above their historical average, though they are expected to revert going forward as profits rebound.
- The equity risk premium and P/E adjusted for CB liquidity injections are still in favour of equities in relative value terms.

DEFENSIVE ASSET ALLOCATION

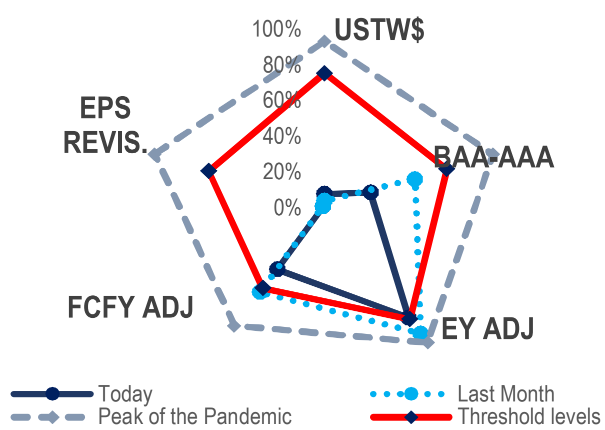
TECHNICALS

- 2021 starts with risk on tone following Georgia elections and fiscal stimulus expectations.
- Signals of overbought risky markets materialised in the latest 2 weeks, mainly RSI indicators and some vulnerability in the reflationary trades in the near term is likely.

SENTIMENT

- With CBs reassuring the market about their support for the global recovery, financial conditions eased further in December, thus leading our risk-sentiment barometer to remain in support of risky assets for the beginning of 2021.
- The USD downward trend and improved perceptions about credit conditions (Moody's Baa-Aaa spread tightened further in December and is currently 10 bps below our alert level) are the key supports for our CAST indicator, which shows a limited probability of a sell-off (CAST OFF probability < 10%).
- Additional supports come from our flow-based risk indicator, suggesting that investor's appetite remains high at cross asset levels (equities and commodities are the segments with a higher risk stance).

Cross Asset Sentinels Thresholds (CAST) still supportive



Source: Amundi Research, Data as of 15 January 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).

<u>Methodology</u> 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 We see a tipping point for UST 10Y yield @ 1.30%

- Notwithstanding the bold Fed purchase program, the UST 10Y yield reached 1.16% (before falling back to 1.0%over the past days). The rise in nominal yields has been driven by break-evens, and the US 30Y breakeven is now above 2%.
- Yield curves in the US have steepened but remain far from previous cyclical highs.
- As long as 10Ys reflects reflationary expectations, it could move even higher but will eventually set a cap for equity valuations.
- Our 2021 target is 1.30% on 10Ys. Medium-term, we expect the Fed to temper yield volatility on the long end to keep financial conditions easy.
- Based on historical evidence, we calculate the empirical distribution of the equity risk premium on the 10Ys, and we believe the tipping point relative to equity valuation is 1.30%.

2 The end of USD exceptionalism

- Despite its sell-off in H220, the USD remains slightly expensive.
- Most of the plunge can be attributable to the end of USD exceptionalism, as both expected growth and the real rate premium vs the rest of G10 FX have collapsed.
- Global conditions and the Fed's "average inflation targeting regime" suggest the USD will remain under pressure, at least in the first half of 2021.
- With a Democratic clean sweep, US growth expectations climbed, and a partial re-rating into US interest-rate expectations has already materialised. We see it as source of short-term volatility but not enough to trigger a new USD bull run.
- A strong rerating in US rates is, in our opinion, the only potential game changer.

3 US growth impacted by fiscal stimulus while Europe is revised down

- Our US GDP growth baseline was 3.7% average 2021 growth with no fiscal stimulus.
- The $900 billion package is adding +1.8% to our average growth forecast, which is now ranging from 5.2% to 5.7%.
- In Europe, we are revising downward our 2021 growth range for the Eurozone (now 3 to 3.5%) as well as for the UK (now 3 to 3.5%).

4 EM growth assessment

- Growth forecast revisions during Q4 2020 have seen a shift in the growth premium towards EMs in 2021 in comparison with previous expectations. Mobility data, broadly decelerating, have been confirming these expectations.
- EM mobility data have declined overall, but less so in Asia with the last period corresponding to the Christmas break.
- China high-frequency data are confirming our view of a sequential slowdown but stronger than originally expected. Our central scenario assumes Chinese GDP to grow by 8.4 to 9% this year.
- We expect EM GDP to grow from 5.7 to 6.5 % in 2021 and 3.9 to 4.9% in 2022.

5 The big disconnect between real economies and financial markets continues

- Market participants are looking with only marginal interest at fundamentals, having full confidence in central banks' keeping the "pedal to the metal" to preserve loose financial conditions.
- We are not in this camp. We think the reporting season is a relevant sanity check moment. Maybe Q1 reporting season will be more insightful than the current Q4 but we think that fundamentals have to come back in the radar.
- We expect a growth rebound in H2, but as long-term investors, we must look at its sustainability over time. The equity markets are racing ahead on the expectation of massive public spending and rapid rollout of vaccines, we are more comfortable with a relative value position than embracing outright risk-on.

Covid-19 update: virus mutations and vaccines efficacy

by David Brecht *Fixed Income Analyst, CFA*

Several recent studies are showing that the three worrisome coronavirus variants (UK, South Africa, Brazil), have the same mutation in the spike protein, and it appears they evolved this mutation separately. The studies have been small and many use pseudo-viruses instead of live coronaviruses, but they show the current approved vaccines will work effectively against the UK variant. However, it does appear that existing vaccines and convalescent blood serum do not provide as much of an antibody response to the South African and Brazilian variants. The mRNA vaccines (Pfizer and Moderna) promoted a very strong antibody response in trials (higher than seen in patients who had actually recovered from Covid infections). Therefore, these vaccines should still have some level of efficacy with the new variants. Moreover, these trials do not factor in other parts of the human immune system that also play a role in fighting infection (e.g. T-cells). Finally, these vaccines will be updated over time to account for mutations; Moderna is talking about the next version of its vaccine, which could be ready two months after being designed. **As time of writing, we therefore believe it is reasonable to assume that mass vaccinations will curb the pandemic.**

AMUNDI ASSET CLASS VIEWS

	Asset Class	View	1M change	Rationale
EQUITY PLATFORM	US	=		2021 is likely to be a strong year for earnings growth, driven by the health of US consumer which has a lot of savings and pent-up demand. However, excessive valuations, potential tax rises, and higher interest rates, coupled with inefficiencies in logistics and higher input costs, require high selectivity. While maintaining the view of rotation towards quality, value and cyclical stocks, investors should move away from companies that will be unable to withstand these pressures.
	Europe	=	▼	We are close to neutral in equities, given that a recovery regime should be supportive, but are mindful of segments where valuations are excessive and discounts have closed in. We suggest a barbell position, with exposure to cyclical, value, segments that can benefit from a recovery, and at the same time, explore defensive names. Above all, investors should continue to focus on non-disrupted business models with strong balance sheets and potential for sustainable growth.
	Japan	+		Japan is a cheap, cyclical market with growing return on equity and an improving shareholder focus which is not yet appreciated by the market. Overall, it is an attractive long-term opportunity tied to a recovery in large global markets such as China.
	Emerging markets	++	▲	We are optimistic on EM, particularly EM Asia. We believe the rebalancing of North Asia towards internal dynamics and demand could act as a good diversifier for portfolios. In addition, the past experience of Chinese authorities in better handling the virus situation should help them deal with new lockdowns. Overall, differentiation is key in EM, and we remain positive on cyclical growth and quality components, but are valuation conscious.
FIXED INCOME PLATFORM	US govies	=		With a global fixed income perspective, investors should remain close to neutral on USTs given their role as a safeguard if economic growth disappoints, but we continue to monitor the direction of rates and inflation. We are more positive on TIPS. From a US fixed income perspective, we are cautious on USTs in light of curve steepening and inflation expectations amid the massive fiscal stimulus (high-debt) plans of the Biden administration.
	US IG Corporate	=		We are neutral/slightly positive overall on IG as Fed actions should support the markets. However, we are cautious on long-duration IG as spreads in general have compressed to close to post-GFC levels. Strong consumer earnings and savings present opportunities in the consumer and residential mortgage markets, particularly in agency mortgages.
	US HY Corporate	=		We believe it is important to defend the additional income offered by high yield credit through security and sector selection. This is all the more important in light of rising yields and inflation expectations. Overall, quality should be a priority, given the risks related to defaults in a low-growth environment.
	European govies	-/=		We are defensive on core Euro bonds as we believe yields are unlikely to fall further, even though the ECB will be continuing its support programme. On peripherals, we stay positive, primarily through Italy, but are closely monitoring the political developments in the country.
	Euro IG Corporate	=/+		CBs' accommodative policies have decoupled markets from the real economy, but appetite for EUR IG remains strong, as reflected in primary markets. The asset class continues to offer positive carry at a time when interest rates are low/negative; thus, investors' search for yield, particularly in the BBB-rated segment, would continue to support IG. However, liquidity and quality should remain a key focus.
	Euro HY Corporate	=		Technicals and fundamentals are supportive of spread compression in HY, but this will not happen across the board. Therefore, we believe investors should be very selective, given the continuing lockdowns and expectations of an uneven recovery and their collective effects on default rates.
	EM Bonds HC	=/+		We maintain our bias towards HC, with a skew towards HY, as we believe IG valuations are now fair. HY is in a better position to cushion the widening effect of UST yields whereas the latter presents a risk to the IG universe. Overall, the US-China relationship under the new Biden administration is still to be assessed.
	EM Bonds LC	+		We stay positive and believe the current environment will still be supportive of EM FX. However, we do not expect to see a much weaker USD. We maintain a preference for high yielders over low yielders in the LC space.
OTHER	Commodities			Oil prices were driven up by the reinforcing convictions on global recovery and ongoing rotation. We revised up our target for 2021 to the $45-55/bbl range for WTI, due to expectations of lower production growth after Saudi Arabia's announced cut. We also reiterate our constructive view on gold, despite the recent correction, as we believe the metal should benefit from a prolonged dovish stance of central banks in the long run.
	Currencies			The USD sold off in 2H20 as both expected growth and real rates premium vs the rest of G10 FX collapsed. Results of the Georgia Senate run-offs gave Dems a clean sweep, providing a boost to US growth and interest rate expectations. However, we consider this to be a source of short-term volatility (especially for low yielders) rather than a clear catalyst for a new USD bull run. Average-inflation-targeting means the Fed should prevent sharp spikes in rates, thereby suggesting fiscal expansion should not come with monetary tightening in 2021. We see a gradual and limited dollar depreciation, which still trades 3% above its average fair valuation. Commodity-related currencies remain the relative winners.

LEGEND

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Negative Neutral Positive Downgrade vs previous month Upgraded vs previous month

Source: Amundi 20 January 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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INVESTMENT STRATEGY

February 2021 #02

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