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When the view is getting blurry, stick to main convictions

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- ***Market reaction**: The further spreading of the coronavirus, especially in Europe, has, in the past few days, triggered a selloff in risk assets and high demand for safe assets (US dollar, Treasuries and gold). As markets reassess the spillover effects of the virus into the economy, volatility is likely to persist.*
- ***Adjusting the economic outlook:** The coronavirus is adding risk to an existing weak trend for global trade growth with fear that some stagflationary forces might result from this crisis (more de-globalisation / weaker growth). In this environment, our central scenario has darkened, with lower GDP growth expectations in H1. The shock could possibly prove stronger in the short term, but we stick with the view that the situation will stabilise at some point in the coming months, leading to a catch-up thereafter, with no long-lasting shock to potential growth. Additional support from central banks and governments to fight any further deterioration in the economic outlook is a key assumption regarding this view. The US appears more insulated and supported by resilient internal demand, while emerging markets and Europe should be the most affected over the short term.*
- ***Investment implications:** The main risk now is the unwinding of recent market complacency (risk assets at historical highs in February) and the reaction of "animal spirits" that can turn into overreaction. In the short term, some profit-taking, risk reduction and increases in hedging are warranted in order to protect investors' portfolios. Our main convictions at the moment are in the credit space – ie, investment-grade Europe – and we also have a positive view on duration in US Treasuries for hedging purposes. From a cross asset perspective, we have become more cautious on equities (European and US), and we have moved to a neutral stance on EM equity. Beyond this tactical view, we believe that the coronavirus can provide opportunities to implement investment convictions that we have identified in our central scenario, exploiting entry points and market dislocations. Cyclical value vs growth, especially in European equities, EM equities with a focus on domestic stories, EM currencies, some areas of the bond market (higher yielding government bonds in EM and Italy) and credit markets (especially the names that are experiencing spread widening despite good fundamentals) should be the first to rebound once the risks of further virus escalation have receded. As the credit market is the main area of opportunity and the main channel of risk, a strong focus on credit selection is key in this phase of the cycle. In addition, a strong focus on liquidity is paramount, not only as a defensive strategy. Liquidity can be put to work to re-enter some attractive areas of the market once the situation stabilises.*

The fears of diffusion of the coronavirus outside China have rattled risk assets in the most recent trading sessions. Investors triggered **some profit-taking** in markets which had reached historical highs and even broken psychological thresholds in previous weeks: this is the case for the European Stoxx 600, which moved above the 20-year broad trading range. The atmosphere of fear has remained consistently high only in so-called safe assets — the US dollar, US Treasuries and gold — signalling that investors have been looking for effective hedging strategies.

"We expect a temporary deterioration of the economic outlook limited to the first half of the year and then a recovery".

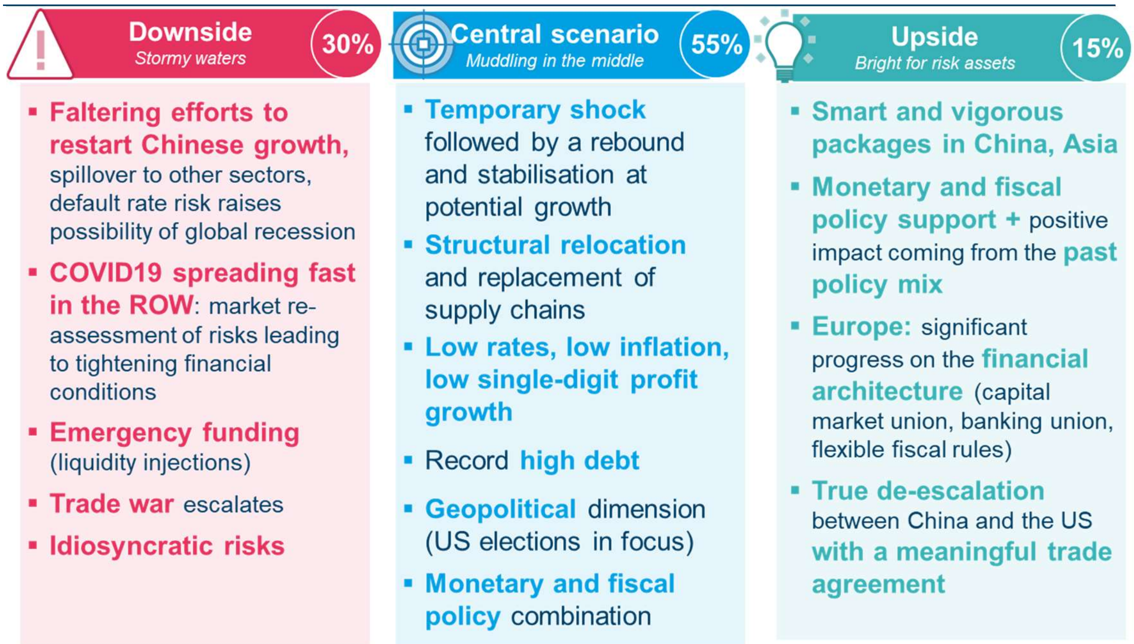
Our central scenario is for a temporary deterioration in the global economic picture during the first quarter of this year, with some possible spillover into the second quarter, given that weaker-than-expected global trade growth is ultimately affecting industrial production and manufacturing activity and there are some impacts on internal demand. After that, **we should see a recovery over the remainder of the year.** We believe there will be a **few months' delay to the cyclical rebound that we had expected at the start of the year.**

To take into account the effects of the coronavirus, **we have revised down the growth outlook for 2020**. The slowdown in China is triggering **massive monetary and fiscal measures to avoid any further disruption in the private sector**. This should help the situation to stabilise in Q2, as we view it as likely that the apex of the contagion will have been reached and activities will slowly return to normal.

Beyond Asia, Europe will be the most affected region, due to a combination of lower momentum, openness of the economy, and exposure to global trade, and weak Q4 data (with surprisingly anaemic growth figures in main EU countries). Also, in this case, there is some downside risk to the current forecast (around 1% for this year), depending on the evolution of the contagion in EU countries, with Italy being the most affected so far. In the US, we confirm a deceleration of GDP growth vs the previous year. However, we believe that the economy will hold up well, thanks to the resilience of domestic demand.

Broadly speaking, **in our scenario, global growth has been downgraded to 3.0% from 3.2%, especially due to weaker EM figures** (4.1% vs 4.4%), considering the spillover effects to some countries deeply entrenched in the supply chain with China (Cambodia, Vietnam, Korea, Thailand) or heavily dependent on metal exports (Chile, Peru, South Africa).

Amundi's base and alternative scenarios



Source: Amundi, Research, as at 24 February 2020. ROW= rest of the world.

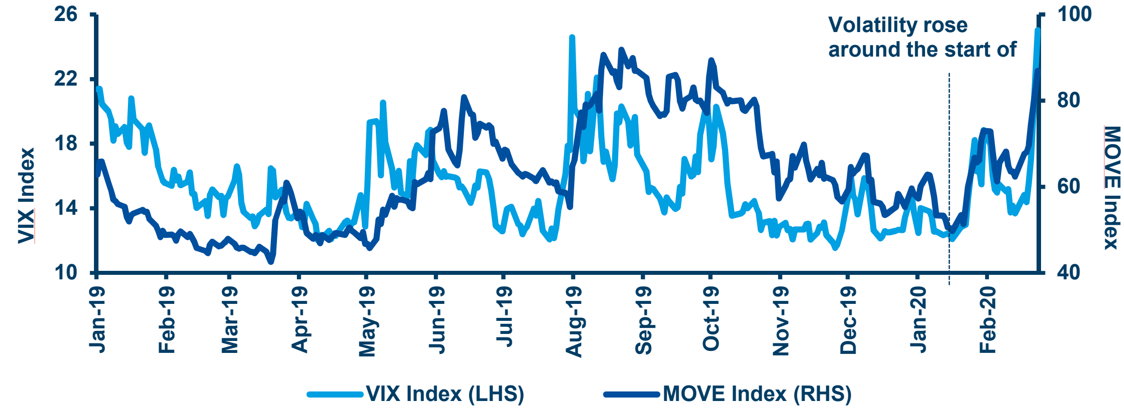
"While in the short term, some profit-taking and risk reduction is warranted, we believe that the year will remain constructive for risk assets and we look for entry points".

In this environment, **we believe that conditions regarding risk assets will remain moderately constructive this year,** but investors should increase their level of vigilance and aim to detect the potential triggers for revisiting this viewpoint.
Clearly, the main risk now is the unwinding of recent market complacency and the reaction of "animal spirits."

Therefore, we can expect to see some profit-taking, short-term market volatility, and overreaction. The good run in risky assets has been driven by the following: investors who believe the coronavirus episode will be temporary (our central scenario); by those who believe that if the situation were to worsen, it will trigger much more central bank action; and, lastly, by those who believe that they have no alternatives, given the moves regarding safe-haven assets.

A tactical move towards neutrality in risk exposure and an increase in hedging looks to be a good strategy to navigate this phase.

Equity and bond volatility has been rising recently



Source: Amundi, Bloomberg, as at 24 February 2020.

"EM equities, EM currencies and European equities, and some areas of the credit markets with good fundamentals should be the first to rebound once the risks of further virus escalation start to recede."

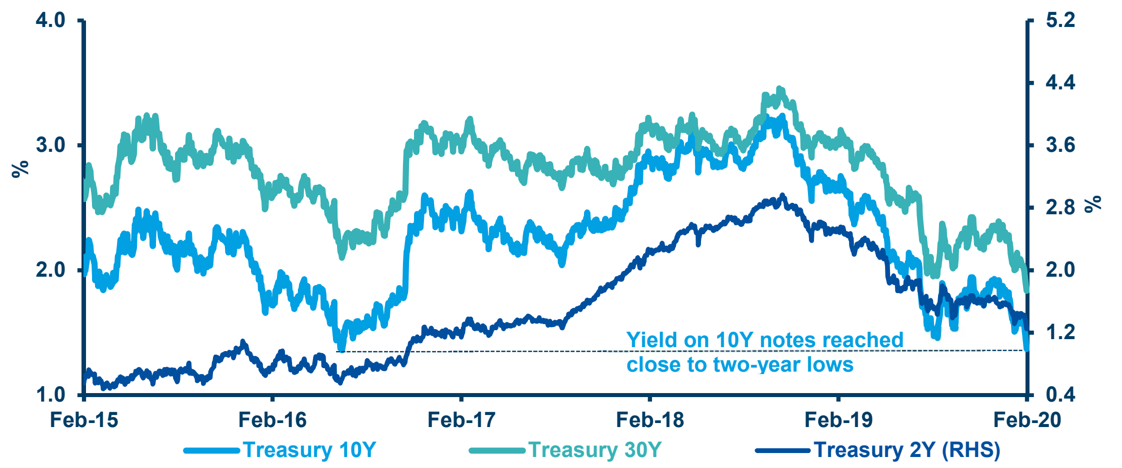
Beyond our tactical view, the coronavirus must be seen as a way to implement investment convictions that we have identified in our central scenario, exploiting entry points in some areas of the markets such as the cyclical value component in European equities (already attractive, but even more so now), EM equities (*help-yourself-countries* or domestic-demand stories) and EM currencies. All these stories will be back in focus once the headlines on the virus recede.

In addition, **falling core bond yields – while reducing some hedging potential, due to the low level of yields reached – should reignite the search for yield in credit markets** or in the **richer government bond segments both in EM and DM (ie, Italy).**

We also should not underestimate the fact that if the situation deteriorates further, central banks and governments could shift monetary and fiscal stimulus to the next level, renewing the narrative of *bad news is good news.*

"Governments and central banks will likely step in should the situation worsen, benefitting financial markets".

Falling US Treasury yields



Source: Amundi, Bloomberg, as at 25 February 2020.

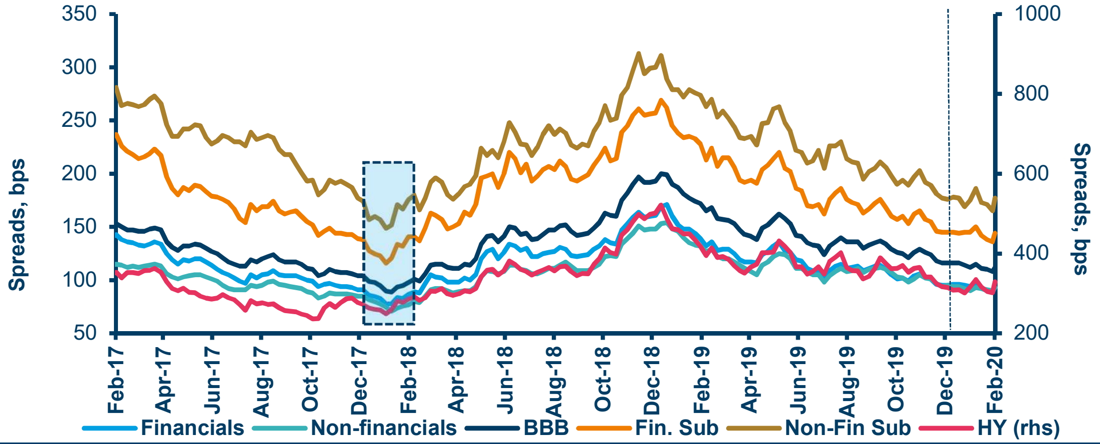
As the main area of opportunity and the main channel of risk lie in the credit markets, the main question for investors is: ***To what extent will the coronavirus generate non-***

idiosyncratic disruptions in this asset class? Disruptions can include increases in default risk, but also liquidity squeezes in the channels of financing (looming risk in China for the private sector). Regarding China, as most of the debt market is government-related, we believe that the government will prevent large-scale shock and material tightening of the financing conditions that could impact the corporate and the banking sectors.

"Credit markets are the place to look at in order to assess risks to the outlook, keeping in mind that some areas are already vulnerable and hence investors should remain selective".

On credit, we should differentiate market and fundamental risks, keeping in mind that market risk can become fundamental risk at some point. Market risks are recoverable events; fundamental risks may well not be. In addition, we need to differentiate between issuers that will fundamentally deteriorate but from higher quality levels, which will ensure no default, and issuers that will deteriorate materially from already low levels of safety margin to default or to flirt with default.

Spreads have been tightening since the start of the year, and we can see some mild deterioration, especially in HY



Source: Amundi, Bloomberg, as at 25 February 2020.

In credit, the biggest short- to medium-term risk is no access to the debt capital and bank markets for any but the best or strongest credits. This condition could mean certain credits may default, leading to a loss of principal. Credits that do not have pre-debt maturities occurring over the next 12 months or longer, credits that are free-cash-flow negative after maintenance capex or low-quality credit private companies that have no access to equity are the most vulnerable. A large majority of low-quality high-yield issuers, B-rated and lower, fall into these categories. Weaker credits that will materially deteriorate in poor economic circumstances are also an issue. These are all idiosyncratic issues, and investors should isolate them.

The second order risk is a material fundamental deterioration in risk-off sentiment and an economically challenged environment. Here, we could experience serious and broad credit deterioration, and a market sell-off, at least in the short term. Companies that have little margin of safety for even non-material revenue or cash flow deterioration would be the most affected. In this case, investors should look at an upgrade in quality to large-cap stable BB/BBBs and the higher-quality IG universe. Scale in this scenario becomes very important and investors should stay away from smaller issuers. Many/most of the companies in this category are US-based, so we can take comfort from the greater US economic resilience at this point. A US recession would have extremely serious credit consequences. Fortunately, Europe has fewer issuers that are currently challenged than does the US.

Both vulnerabilities (market and fundamental risk) reinforce our view of the credit sector requiring increased scrutiny, with a focus on bottom-up credit research and increased attention on market liquidity.

Overall, we expect that the credit market will remain resilient, especially in the IG space (Euro is better positioned), while the HY market will continue to be under pressure, but offering some attractive entry points as the situation normalises.

"Some trends will be further reinforced by the current environment: the continuation on the de-globalisation path, the low interest rates environment and the demand for real assets."

On a longer-term perspective, the coronavirus confirms some pre-existing trends:

- **The retreat in global trade and de-globalisation.** This should support investment themes insulated from those issues, such as domestic-driven demand countries in EM or a focus on more domestic real assets.

- **Low interest rates at equilibrium**. Core bonds (US) are providing a cushion for risky assets in reaction to setbacks (negative immediate correlation between equities and bonds), but they should also lead the rebound of risky assets (negative leading correlation bond yields/equities). It follows that duration management must be asymmetric: it is much more risky being short duration than long duration, and there is a clear role for Treasuries in portfolios for their hedging properties. In this scenario, interest rate factor dominates the growth and earnings components of equity returns. Investors should be alert to the early signs of either a change in equilibrium rates or a shift pointing to more prominence for the real component of returns vs the monetary component, but we are not yet at this point.

- **Demand for real assets.** The absence of real illiquid assets is a recurring weakness as they represent an already large, but still rising component of relative value plays. De-globalisation is driving demand for real estate on the basis that it provides significant international geographical diversification. The search for a better remuneration of the interest factor (infrastructure) or simply equity-like returns with bond features is also driving demand. This mismatch in supply and demand, along with trade and pandemic noise, can only accentuate this sort of safe-haven status with fast rising complacency.

Definitions

- **Credit spread:** differential between the yield on a credit bond and the Treasury yield. The option-adjusted spread is a measure of the spread adjusted to take into consideration possible embedded options.
- **Real assets:** physical assets that have an intrinsic worth due to their substance and properties. Real assets include real estate, natural resources.
- **Volatility:** a statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.
- **MOVE:** MOVE Index is the Merrill Lynch Option Volatility Estimate for the US Treasury.
- **VIX:** VIX is the CBOE volatility index. The VIX index is a measure of market expectations of near-term volatility on the S&P 500 (US equity).

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