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Contraction→ recovery→ late cycle: a cycle round trip in three years

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The pandemic outbreak altered the cycle of financial regimes we had in mind at the end of 2019

The pandemic outbreak altered the cycle of financial regimes we had in mind at the end of 2019, with consequences extending over the medium term: after a sharp contraction in 2020, 2021 will see a "recovery" in the growth and profit cycle with a rebound in risky assets while in 2022, we expect a normalization towards a late cycle.

Macroeconomic backdrop

The geographical impact of the pandemic has extended globally over time, quickly evolving from an external shock to trade dynamics sourced in China to an endogenous shock of collapsing demand in most countries experiencing forced shutdowns.

While different timelines of the outbreak and related containment measures suggest a jerky recovery, with the risk of possible setbacks should a second wave of epidemic/lockdown occur, single economies are facing double shocks, both domestic and external.

Real GDP growth is expected to fall Q1/Q2/Q3 2020 hit by the pandemic and global economic lockdowns.

On the inflation front, the mix of lower oil prices and weaker prospects of global growth suggest a shallower path for inflation across the globe in the near term, with widening output gaps slowing the pace of core inflation, and lower oil and commodity prices providing a drag on headline inflation.

Because the peculiarities of the economic fallout, targeted fiscal, monetary, and financial market measures are being deployed to support affected households and businesses domestically.

Monetary policy across the globe has swiftly responded to the emergency, tackling the situation with new tools and instruments, acting to provide liquidity to markets and the financial system. The Federal Reserve has cut its main policy rate back to zero, using all its firepower on rates, cutting by a cumulative 150 bp, while providing coverage of huge fiscal needs through unlimited QE. The ECB took several steps and ultimately delivering a strong package. It acted on preannounced targets, providing ample liquidity to the financial system, and delivering a huge increase in QE2 and de facto ceiling intra-EMU spreads, and providing support to governments' higher funding needs.

The fiscal response has been sizable in most advanced economies, and many emerging markets economies have also begun announcing significant fiscal support for sectors that have been hit. Measures aim at reducing the impact on the hardest-hit households and businesses, while preserving economic relationships and activities as the pandemic outbreak forces lockdowns. The size of tools depends on the fiscal room available at the national level, although in the Eurozone a more coordinated effort is gradually shaping up.

Investment Phazer medium-term implications: a contraction followed by a recovery supported by massive policy coordination and eventually a late cycle, or potentially asset reflation, should central banks continue to expand their balance sheets. The first phase is characterized by a preference for cash, Govies, IG under the central banks' and gold.

The next step will be to move to EM equity (first-in, first-out), base metals and HY, as soon as the profit cycle bounces back, while the latter stage will be broadly repositioning in DM equities and the full credit spectrum.

The pandemic outbreak altered the cycle of financial regimes we had in mind at the end of 2019…

Given our macroeconomic assessment, we expected a financial regime of "contraction", but the pandemic's consequences will persist over the medium term (three years), changing the financial cycle until 2022. In 2021 we shall see a "recovery" phase in growth and a profits cycle supported by relief in economic activity (changing our previous expectations of an economic slowdown and a profit recession to take place in 2021). In 2022, we expect a normalization towards a late cycle. Should central banks persist in their accommodative stance (primarily through balance sheet expansion), we could even move into an asset reflation regime (similar to 2013-17).

… while current risky assets prices, multiples and valuations are not pricing in the profits recession we now expect for 2020. The forthcoming reporting season will be highly uncertain but crucial in sizing the Covid-19 damages to the real economy. We expect a free fall in 1H20, followed by a partial recovery in 2H20, driven by a gradual global lockdown easing.

The final outcome should be a deep profits' recession. In our central case, we expect S&P 500 EPS to fall by -25% in 2020 (the duration of lockdowns will be key), followed by a rebound of the same size in the following 12 months. The exceptional nature of the

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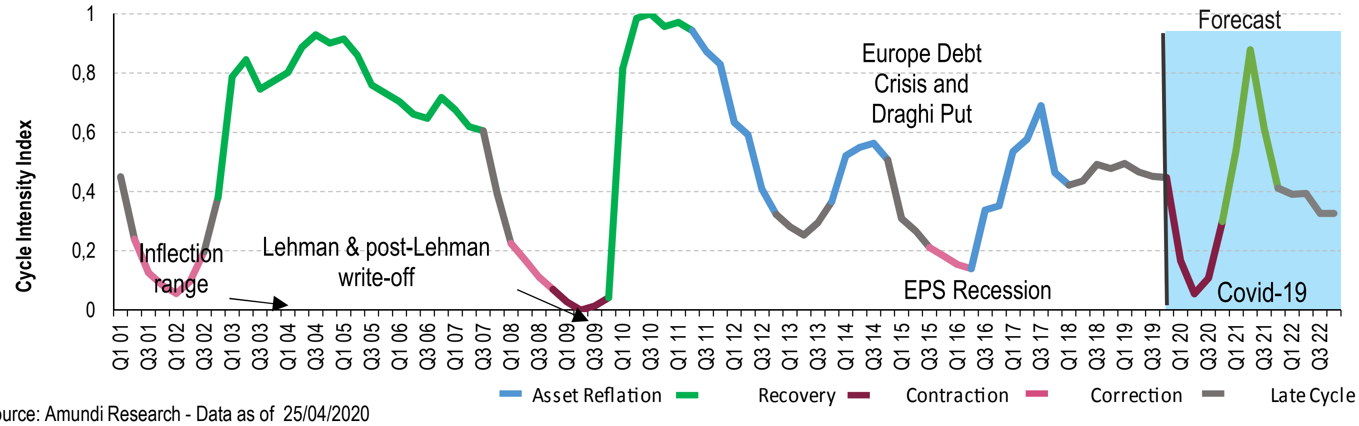
recession, the biggest and fastest since the Great Depression, should help bring about a faster recovery than has usually happened in the past.

The resilience of earnings and markets sentiment would help equities making new highs in 2021-22 without stretching valuations.

2021 operating EPS are expected to be resilient and higher than before the global economic lockdown. We expect the S&P 500 to recover in 2021 by around 25% in line with the rebound in profits. We believe the index could drift higher in 2022 as well, although at a more normalized rate (close to +8%). Therefore the risk is skewed to the upside, and the average returns (post the 1Q20 correction) on a three-year horizon should be close to double digits. This scenario with a combination of EPS rebound and S&P 500 making new highs is consistent with past bounce-backs after equity corrections, and the expected PE will move to the median of historical realized PE. Markets will not be expensive in relative value terms either, as interest rates should remain low helping credit to deliver good risk-adjusted returns.

1/ Medium term view: advanced investment phazer

A contraction followed by a recovery supported by massive policy coordination and eventually a late cycle, or potential asset reflation, should central banks continue to expand their balance sheets.



Source: Amundi Research - Data as of 25/04/2020

Financial regime mapping according to the investment phazer

Financial regimes	Macroeconomic parameters behaviour				Investment implications	
	Growth	Inflation	Monetary Policy	Financial Conditions	Cross Asset Evidence	Cross Asset Preference
Slowdown	• Growth below trend level • Below trend EPS growth	• CPI, PPI below trend • Falling ULC YoY growth	• Easy conventional MP • CBs balance sheet growth at trend levels	• Financial conditions start to be tighter	• Global equity suffer • IG preferred to HY in credit • Gold good hedge • Volatility increases	• Govies • Gold • Investment Grade
Contraction	• Growth far below trend level • Falling EPS	• Inflation far below trend	• CBs very accommodative • Excessive CBs balance sheet growth	• Tight financial conditions	• Credit and global Equity unattractive • Safe to quality • Lack of trust • High volatility	• Cash • Gold • Govies
Asset Reflation	• Growth at trend level • Above trend EPS growth	• Inflation below trend	• CBs very accommodative • Excessive CBs balance sheet growth	• Easy financial conditions	• Global Equity rises • Bond yields fall • Most assets do well • Volatility stays low	• Global Equity • High Yield • Commodities
Recovery	• Growth expanding far above trend level • Strong EPS growth	• CPI, PPI above trend levels • Above trend ULC YoY growth	• Tight conventional MP • CBs balance sheet growth below trend level	• Easy financial conditions	• Risky assets the most attractive • Commodities and EM Equity rally • High volatility	• High yield • Base Metals • EM Equity
Late Cycle	• Growth expanding slightly above trend level • EPS consolidation	• Inflation rises towards targets	• CBs correction (less easing)	• Easy financial conditions	• Bond yields rise • Global equity consolidates • HY rotation into Equity • Volatility Increases	• DM Equity • Investment Grade • High Yield

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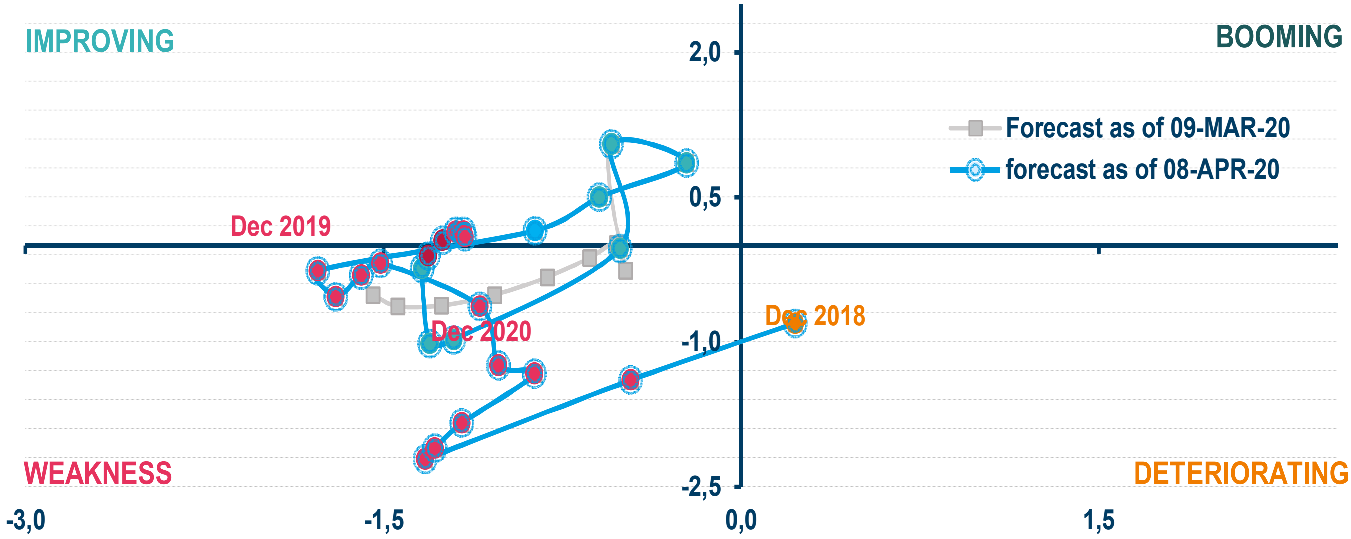
2/ Short term view: Global composite economic momentum

Economic momentum : Swinging around the Investment Phazer

On a shorter term perspective, the pandemic triggered a sequence of "pain": our Composite Economic Momentum Index (CEMI) dropped into the "weakening" quadrant on soft data collapse in Asia and moved even deeper as the pandemic outbreak in Europe. The negative EPS revisions touching historical lows leave little hope of improvement, in 2020. This is consistent with the contractionary financial regime flagged by the Investment Phazer.

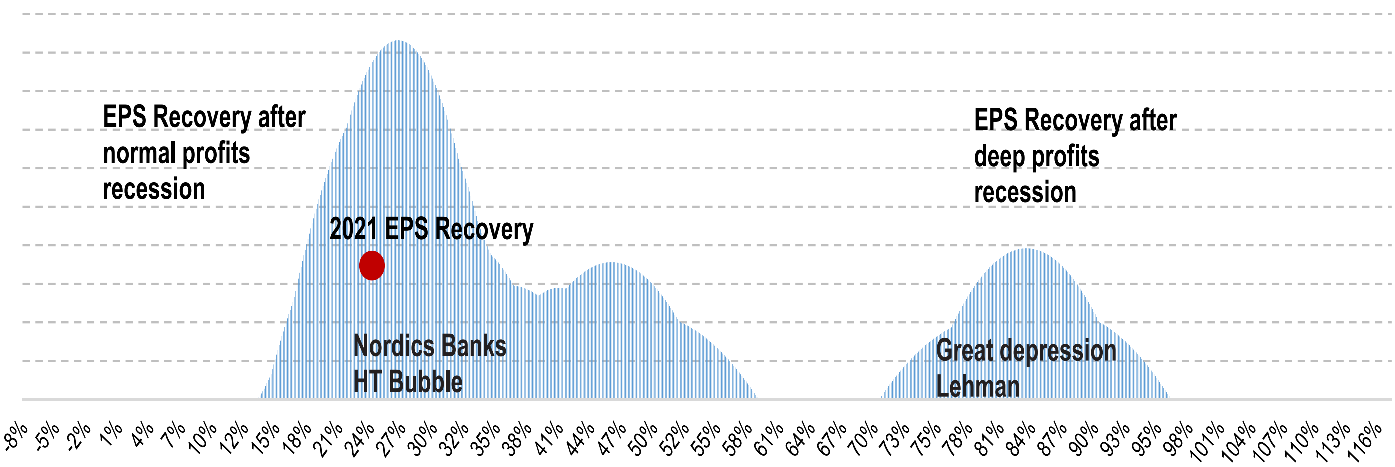


Source: Amundi Research - Data as of 10/04/2020

The Global Economic Momentum index is an Amundi proprietary indicator based on four regional baskets (US, Eurozone, Japan and EM) and on the following variables: earnings revisions, 10Y interest rates, leading indicators, CPI YoY, PMI surveys, the Economic Surprise Index and the Inflation Surprise Index. We consider the level and the momentum (variation) of the index in order to define four economic cycles: **Booming:** uptrend level and positive momentum; **Deteriorating:** uptrend level and negative momentum; **Weakness:** downtrend level and negative momentum; **Improving:** downtrend level and positive momentum.

3/ The magnitude of profits recovery in 2021 will depend on 2020 pain

From an empirical perspective, EPS recoveries are bimodal and anchored to two pivots linked to the magnitude of the preceding recessions. In the US, a profit recession in the -25% range is followed by a rebound of a similar amount. We expect to confirm this pattern in 2020/21. Besides, larger losses (below - 50%) had historically been followed by rebound of around 85%.



Source: Amundi Research - Data as of 24/04/2020

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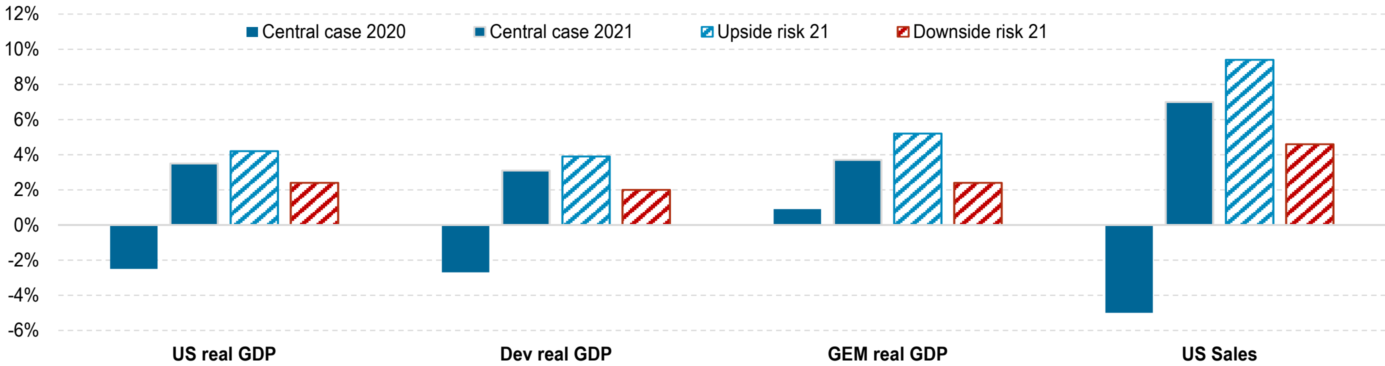
4/ Growth under central and alternative scenarios

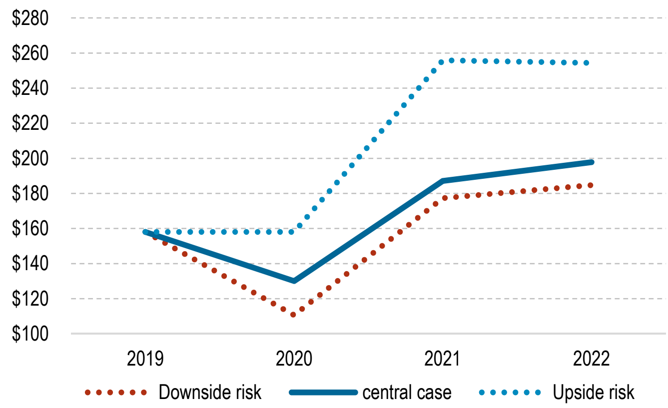
Growth is expected to recover in 2021 to potential in the US and Developed Economies but still below potential in Emerging Economies. While guidelines remain uncertain, we expect the top line to improve eventually.



Source: Amundi Research - Data as of 24/04/2020

5/ S&P 500 aggregate earnings simulation

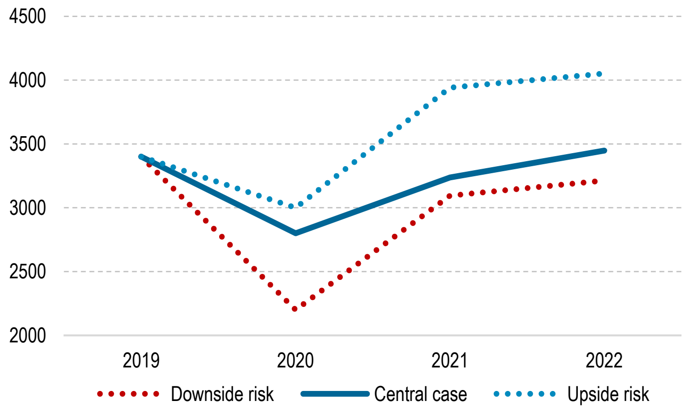
S&P 500 2021 EPS are expected to be resilient and to move higher than before global economic lockdown.



Source: Amundi Research - Data as of 24/04/2020

6/ S&P 500 levels simulation

We expect the S&P 500 to recover in 2021 by 25% in line with the rebound of profits and to drift even higher in 2022, albeit on a more normalized pace (+8%). The risk is skewed to the upside.

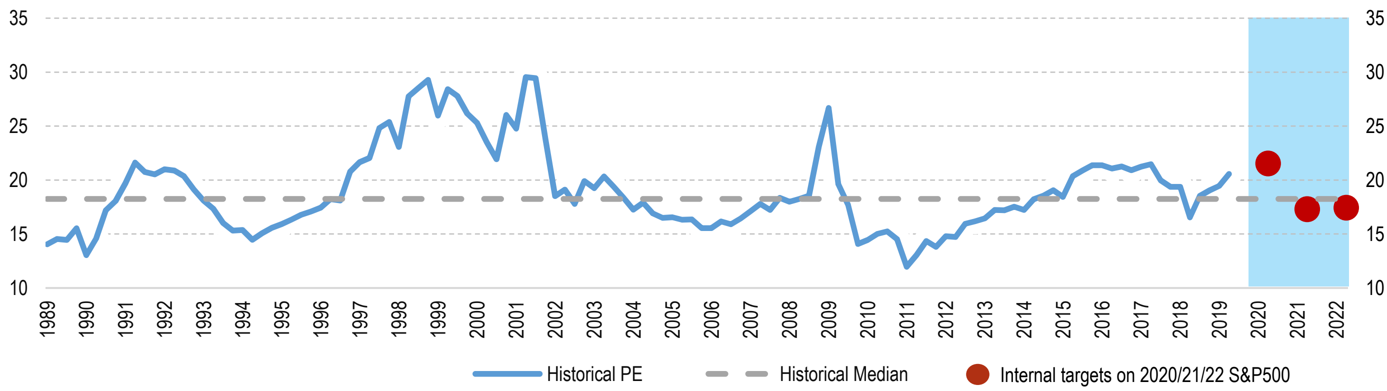


Source: Amundi Research - Data as of 24/04/2020

Methodological note: LTM EPS simulation is the outcome of patterns generation based on the sequence of identified phases by Amundi's Research proprietary tool AIP. The downside and upside are calculated according to the simulated distribution centered on the central case scenario.

7/ S&P 500 price earnings (historical and targets)

Combining our expectations on EPS and S&P500 levels, we expect PEs to move back to the historical realized median. Consistently with past dynamic, a spike is likely on the bounce back once equity market corrects.



Source: Amundi Research - Data as of 24/04/2020

Operating S&P500 PE (Actual) is defined as the ratio S&P500 level / Realized Operating LTM EPS
Historical median: Historical median of Operating S&P 500 PE (Actual), sample: 1989-2019

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Implication for the labour market: key to assess the shock size on the demand side

While different timelines of the outbreak and related containment measures point to a jerky recovery, with the risk of possible setbacks should a second epidemic/lockdown wave occur, single economies are facing double shocks, both domestic and external. On the domestic front, major concerns are related to the vulnerability of the labour market, with implications on disposable income, spending and saving patterns in both the short and longer term. In addition, the path for capex remains highly uncertain while disruptions to local and international production chains will affect imports/export dynamics and global trade overall.

Of particular concern is the impact of the lock-down measures on the employment front. Indeed, many workers employed in temporary jobs and in so-called “proximity” activities are at risk of seeing their jobs eliminated or their hours reduced. In the US, the surge in jobless claims since the first lockdown measures has been unprecedented, and in few weeks wiped out all jobs created in a decade of economic expansion. For the US economy, this should translate into an increase in unemployment, which could spike temporarily to a range 14% to 20% and then revert to more moderate rates as the economy reopens. We expect the US unemployment rate to average approximately 10% in 2020, and then gradually revert towards the NAIRU. However, to see a reversal in the unemployment trend, we will need to see a rebound of the corporates' profits first.

In the Eurozone, to prevent a surge in unemployment, national governments have made some extraordinary schemes available to a broader than usual group of companies, which agree to avoid laying off any of their employees but instead reducing the working hours of all or most of them, with the government making up some of the employees' lost income. This is particularly important in Eurozone where the labour market ability to adjust to the down cycle and to recover afterwards may be slower. The German Kurzarbeit plan is the ideal reference, and the more effective that national plans are in replicating this model, the less likely unemployment will jump well beyond the levels seen after the GFC and sovereign debt crisis. In a case of only partial effectiveness and deep contraction in activity, in line with our central case, we could see unemployment rise to between 8.5% and 25%, depending on the countries, as pre-crisis starting points were different. Most vulnerable labour markets, such as Spain and Italy, may pay the higher costs of ineffective implementation of such workers protection schemes.

US unemployment projections under various scenarios

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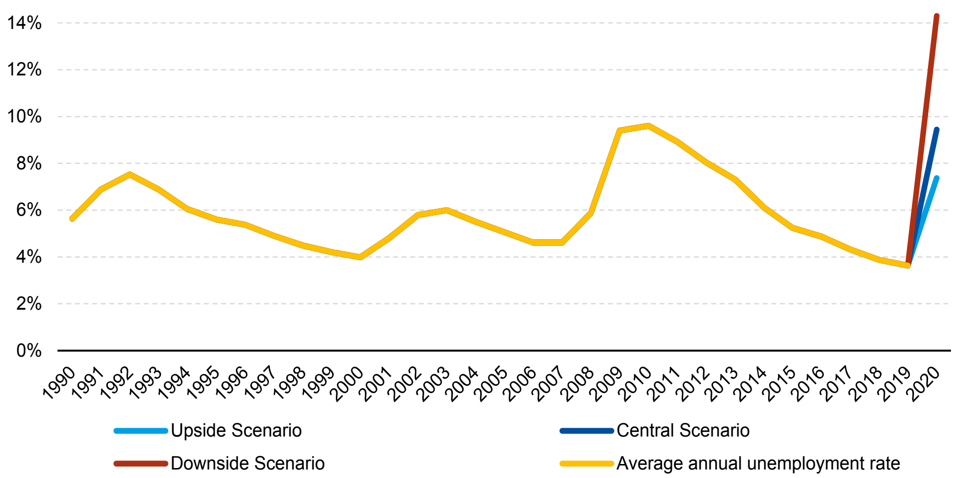

Source: Amundi Research - Data as of 24/04/2020

The shock on the demand side, in regions where labour is less flexible as employees are on average more protected, such as in the Eurozone, might materialize later, delaying the recovery. This is why we welcome the SURE plan approved by the EU commission to temporary support and mitigate unemployment risks.

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