CENTRAL & ALTERNATIVE SCENARIOS

Monthly update

This month, we update the probabilities and narrative of our central and alternative scenarios, taking into account 4Q20 developments in vaccinations, fiscal and monetary policies, and (geo)politics. We have a higher conviction on our central scenario and we are raising its probability from 65% to 75%. We are lowering the probability of our downside scenario from 25% to 15%, which remains above historical levels. 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
- Policy mistakes and execution risks of fiscal plans
- Pause or rollback of accommodative monetary policies, due to internal (asset bubble) or external (FX) constraints.
- Protracted economic downturn, due to uncertainty (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 1H 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: 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
- 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
  - 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 on social groups, could undermine the recovery
- **A rebirth of inflation and a second taper tantrum**
  - The risk is very low in the short run, but upward inflation pressure 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**
  - In the wake of the US elections the hawkish tone from Democrats is bringing new policy uncertainties to the bilateral relationship
  - 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 Covid-19 second wave led to the introduction of new lockdown measures across the EU, causing a renewed contraction in Q4 2020. Similarly, a deceleration in economic activity took place in Q4 in the US, as Covid-19 cases have surged to record highs.
- Soft and hard data confirm these trends, with the manufacturing sector holding up better than services as it is less disrupted by the latest restrictions.

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.

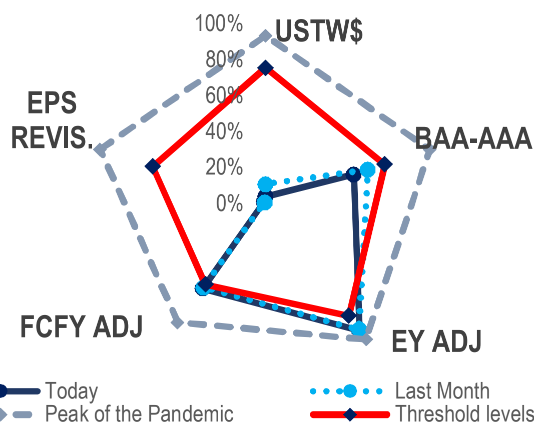
TECHNICALS

- We entered the last month of 2020 with all risky assets in overbought territory, driven by the outcome of the US election and positive Covid-19 vaccine developments which have been strong catalysts.
- Tighter restrictions over the Christmas period in many DM countries and some profit-taking before year-end reduced the momentum in risky assets. This points to a lack of clear-cut directionality when looking at trend following or pure contrarian signals. High yielders in fixed income (HY Corp US and Europe, GEM Bonds) are the most stretched segment at the cross asset level.

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 downward trend of the USD 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 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 22 December 2020

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).

Methodology 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 Hidden YCC by the ECB

- Technical factors will continue to play a major role in the euro fixed-income market.
- Unused PEPP + additional QE will more than cover 2021 net new issuance, due to higher deficits. The ECB will buy 70% of 2021 Gross Sovereign Supply.
- This is the end of Bund's volatility. Marketable on overall sovereign debt is lower for Germany than for other major European countries: 73% vs ratios between 83% and 87%. This is the first factor supporting Bund scarcity.
- The extended PEPP can be re-calibrated at any point in time. This is YCC (Yield Curve Control) without saying it.

2 How far the "great rotation" can go

- After the strong rally in risky assets, we see more opportunities in lagging sectors and styles, rather than in regional allocation.
- While Europe usually performs in line with US equities during a recovery phase, this unusual recovery favours European cyclicals and its financials. The same applies to Japan (Value and Growth) relative to the US.
- Value vs. Growth mean reversion is just starting and has room to expand further. The positive signal is that the correction of the valuation gap between the two is materializing, with Value catching up, and not through a burst of a Growth bubble, which is a positive signal for pro-cyclicality.
- Until bond yields are below the average nominal growth expectations over the course of the cycle, it will mainly be the speed of adjustment of the bond market that matters. Provided that CBs don't allow rates to move quickly, and corporate earnings growth keep rising, there is enough time for the rotation to play out.
- Georgia's Senate runoffs results should further boost the rotation out of USA into RoW, once markets digest the potential of higher tax and regulatory implications from a full Democratic government.

3 FX matters

- On the USD, the expectation of stronger growth in 2021, fueled by vaccine hopes, spurred risk sentiment and almost filled the undervaluation gap, while the Fed removed almost entirely the USD rates advantage that made the greenback a profitable opportunity on top of a defensive play.
- The ECB will also continue to monitor developments in the exchange rate. It's not the current level of the EUR but the pace of its appreciation looking ahead that is likely to worry the ECB (with a stronger pass-through to prices at a time when inflation is already in negative territory).
- Global determinants remain the key factor to watch. We see commodities performing in line with nominal GDP, a mild steepening of the curve and Value outperforming Growth: NOK, AUD, SEK and CAD show the highest risk /reward profiles. There's too little to squeeze from NZD, EUR and GBP.

4 EM equities as the recovery play

- EM Central banks remain accommodative, but the pace of yield compression is going to decelerate, and inflation is expected to normalize to higher levels.
- EM FX is still undervalued on average. We see +0.5% upside on a three-month horizon. The potential EM FX upside is higher in GBI-weighted terms (+0.8%). We remain positive on some Latam countries like MXN and PEN, as well as for IDR, RUB and some Asian FX, such as CNY, which are more advanced in the economic recovery and in controlling Covid.
- HC bonds show limited room for further spread compression in 2021 even if we expect lower volatility in 2021 compared with 2020. We still see more room in H12021 for HY. Our scenario for USD depreciation is not supportive.
- EM equity earnings growth is being driven by the rebound in world trade, emerging exports and a mild but positive increase in commodities prices. Profits growth in the first half of 2021 will be more concentrated in Emerging Asia, which is much more advanced in the recovery and more linked to booming e-commerce profits and the secular trend of technology. The region remains safer and should continue to outperform, involving laggards such as Indonesia. We see room in the next months for some rotation into laggards and value places like Mexico and Russia.

Covid-19 update by David Brecht, *Fixed Income Analyst, CFA*

As the rollout of approved vaccine is under way across the globe, two more vaccines from J&J and Novavax have near term chances of approval. If approved, the J&J vaccine would massively increase the supply with one billion dose targeted in 2021.

There is a lot of concern around two new variants of the coronavirus, one in the UK (B.1.1.7) and the other in South Africa (B.1.351). Both variants have mutations in the receptor-binding domain, which is where the virus binds to the host cell. Both variants are much more contagious, which just could be because a person exposed to the variant is more likely to get infected or because a person sick with this variant sheds and therefore spreads more virus. The South African variant also has some additional mutations that could negatively affect vaccine efficacy. These mutations are on the virus' spike protein, which is also the target of the vaccines and antibody therapies.

The UK variant does not appear more lethal but supports the hypothesis of Covid being endemic. Moreover, vaccines in development are all polyclonal and there is no evidence that any mutations so far make a vaccine ineffective. Vaccines can also be updated (6 weeks according to BioNTech) and most vaccines should continue to be effective.

AMUNDI ASSET CLASS VIEWS

	Asset Class	View	1M change	Rationale
EQUITY PLATFORM	US	=		The “blue wave”, with the Democrats taking control of the Senate should further support the rotation towards value themes. It has to be monitored for the potential effects on taxation and legislation on big corporation. In addition, equities are attractive vs fixed income as earnings yields exceed corporate IG yields and the gap between dividend yields and the 10Y Treasury yield is huge. Looking ahead, economic recovery in 2021 and earnings improvement should be supportive. However, investors should be mindful of excessive valuations and should explore rotation towards quality Value and cyclical stocks as well as ESG themes.
EQUITY PLATFORM	Europe	=/+		We stay mildly optimistic as a vaccine rollout should support normalisation of the economy, but we believe a sustainable rotation favouring Value and cyclical depends on economic recovery, continuous fiscal push, and the direction of interest rates. However, investors should remain focused on businesses with potential for long-term earnings growth and resilient business models.
EQUITY PLATFORM	Japan	+		Pro-cyclical markets, such as Japan, with a large share of industrials and consumer discretionary sector, should benefit from an economic rebound as well as from close trade linkages with China. In general, the high operating leverage of businesses in Japan should be positive for profit margins as a result of higher sales in 2021.
EQUITY PLATFORM	Emerging markets	+		We remain constructive in light of a potential large-scale vaccine availability and as investors put more money to work away from low remunerating assets. Asia is our favourite area, but the improvement in economic conditions should support Latam and Cemea next year as well.
FIXED INCOME PLATFORM	US govies	=		In global portfolios, we are close to neutral on USTs, but are actively monitoring the direction of rates and curve movements in light of fiscal stimulus discussions and expectations of curve steepening. Instead, we prefer TIPS. With a US fixed income perspective, USTs offer good liquidity, but could come under pressure as the growth outlook improves. So, we are cautious.
FIXED INCOME PLATFORM	US IG Corporate	=		We remain neutral/marginally positive amid Fed support for the markets, but acknowledge that IG spreads have tightened. In securitised credit, consumer and housing markets present selective opportunities as US consumer and savings remains strong and loan/value ratios are low.
FIXED INCOME PLATFORM	US HY Corporate	=		HY offers that extra income in a low rate world supported by Fed action, but we are very selective in view of default risks and a slow recovery. Going forward, investors should differentiate between companies that have the capacity to repay their obligations vs those that are being helped by artificially low borrowing rates.
FIXED INCOME PLATFORM	European govies	-/=		We stay cautious on core Euro government bonds due to overvaluation and see limited risk of yields dropping further, although the ECB will maintain its supportive policies, as highlighted in its latest round of stimulus. However, we are positive on peripheral debt, mainly through Italy, amid a strong EU policy response, even though we think prospects of spread compression in this space are now limited.
FIXED INCOME PLATFORM	Euro IG Corporate	=/+		Euro IG offers opportunities in the ‘search for yield’, particularly in the BBB segment. The scope for further spread compression is limited, and investors should lock in gains where the potential for further tightening is limited. A focus on quality and liquidity must be maintained.
FIXED INCOME PLATFORM	Euro HY Corporate	=		Spread tightening will not be uniform across the board. Instead, the case for selectivity is as key as ever and investors should use research as a means of balancing yield with quality and should steer clear of very-low-quality names.
FIXED INCOME PLATFORM	EM Bonds HC	=/+		We keep our benign outlook for EM debt, but continue to see better risk/reward in HY, and while spreads are tighter, there is still room for compression. We stay mindful of the potential risk on the duration side in IG, if there is further pressure on USTs.
FIXED INCOME PLATFORM	EM Bonds LC	+		We are positive on LC bonds because of expectations of USD weakness. On FX, a global low-yield environment, benign inflation, stable US policy, and an early-cycle growth environment all support EM local currencies.
OTHER	Commodities			Oil prices moved up over the past month, reinforcing our conviction about a global economic recovery and an ongoing rotation. Nonetheless, we confirm our 2021 price target range of US$40-50/bbl for WTI. We also reiterate our constructive view on gold, despite the recent correction. Gold will benefit from a prolonged dovish stance of central banks.
OTHER	Currencies			Despite most of the G10 FX undervaluation gap (vs the USD) has been absorbed, a shift from ‘Contraction to Recovery’ suggests that the greenback has more room to correct lower, at least in 1H21. In addition, our central scenarioof a global recovery sees commodities performing in line with nominal GDP, a mild steepening of the yield curve, and Value outperforming Growth. All of these factors are likely to weigh on the dollar, which is still about 3% above its average fair valuation. In this environment, the NOK, AUD, SEK and CAD show the highest risk/reward profiles.

LEGEND

Negative Neutral Positive Downgrade vs previous month Upgraded vs previous month

Source: Amundi 21 December 2020, 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.
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