CENTRAL & ALTERNATIVE SCENARIOS

Monthly update

This month, we do not amend the narrative of our central and alternative scenario. Economic data confirm a slower recovery path in line with our central scenario and Central Banks maintain their accommodative stace. We maintain the probability of our central scenario at 70%, 20% for the downside scenario and 10% for the upside.

DOWNSIDE SCENARIO 20%

Secular stagnation

Analysis

- Economic relapse (Q4 2020/Q1 2021).
- Policy accelerators in place but with diminishing impact: liquidity does not feed through to the real economy and the labour market suffers fading employment benefits.
- Economic crisis evolves into a financial crisis.
- Protectionism and deglobalisation accelerate, negatively affecting trade and global value chains.
- Vaccine efficacy is limited and/ or people's compliance is poor

Market implications

- Favour cash and US Treasuries.
- Favour gold, CHF, Yen, NZD.
- Use minimum volatility strategies.

CENTRAL SCENARIO 70%

Slow U-shaped recovery

Analysis

- Short-term rebound (Q3), flatter and gradual convergence to pre-crisis levels, with significant divergences on timing. Economic backdrop still in the grip of the pandemic as a vaccine won't be available before H2 2021.
- Credit fragmentation and rising default rates.
- Debt monetisation and ballooning CB balance sheets.
- Global trade recovers on economies re-opening, driving the global cycle as well as domestic engines.
- Widening social gaps and inequalities

Market implications

- Sideways dynamics prevent directional positioning.
- In fixed income, be active in duration management (favour US, EU peripherals), prefer carry to beta.
- Long BBB/BB, very selective on low high yield rated issuers, cautious on EM FX. USD to be monitored.
- In equities, for the rally to continue a widening of the market's breadth beyond the FAANGs is required. Prefer long-term winners, maintain the tilt to cyclicals.
- Favour gold on pervasive uncertainty.

UPSIDE SCENARIO 10%

V-shaped recovery

Analysis

- Economic activity recovers to pre-crisis levels by mid-2021 (US, Eurozone), with above-potential growth in H2 2020 and H1 2021.
- Pandemic almost eradicated with medical treatments for cure and prevention. A vaccine is available H1 2021.
- Monetary and fiscal stimuli feed through to the real economy and financial markets.

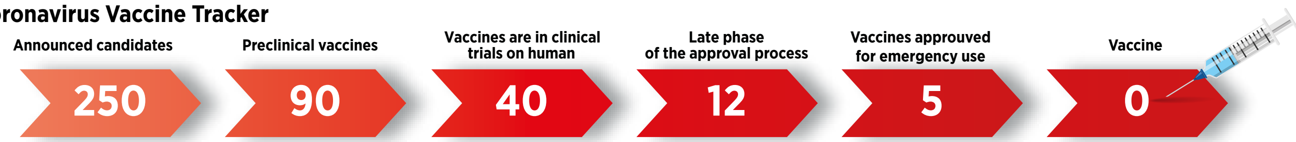
Market implications

- Favour risky assets with a rotation from credit to equity and commodities (oil).
- Favour linkers.
- Negative USD driven by negative interest rates and widening interest rate differential with the RoW.

Covid-19 update: the race for a vaccine

As the northern atmosphere begins to get colder and a second wave hits Europe, scientists around the world have high hopes of finding a vaccine to stop the SARS-CoV-2 coronavirus. At the time of this writing, 40 vaccines are in clinical trials on humans with more than a dozen in the late phase of the approval process, and around 90 preclinical vaccines are under active investigation in animals out of 250 announced candidates. Most specialists expect a vaccine with scalable production capabilities to be available early 2021 or mid-year at the latest. The key factors behind this unprecedented medical search and the likelihood of success are the slow mutation of the virus, the large number of technology platforms being used, and access to almost unlimited funding. The race for a vaccine is in its last laps. Then will come the tough decision of who gets it first.

Coronavirus Vaccine Tracker



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 probabilities on the risk outlook with the pandemic exacerbating existing fragilities and vulnerabilities.

ECONOMIC RISK 10%

- **New lockdowns to tackle new waves**
  - Although our ability to deal with the virus has improved significantly (e.g., treatment, health infrastructure, and social distancing), the fallout in sentiment, consumer spending and the economic recovery could be negative, and trigger a W-shaped recovery.
- **No V shape recovery but a dismal labour market**
  - After a fast recovery the economy might slow down or even decelerate
  - While all policy efforts and social benefits have been activated to preserve personal income, the deterioration of the labour market might still derail the recovery
- **Inflation surprises**
  - QE programs may become problematic during a recovery when inflation enters the equation.
  - The Fed is moving to average inflation target
  - Inflation dynamics and the CB reaction function could be sources of uncertainty. In particular, EM inflation is at an inflection point but the trend ahead remains comfortable due to depressed demand (watch Turkey, India and Mexico)

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

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

FINANCIAL RISK 15%

- **Mounting corporate vulnerability**
  - Prior to the Covid-19 crisis, corporate leverage reached levels above pre-GFC highs
  - The magnitude of the recession will increase solvency risks regardless of central banks' actions and government guarantee schemes
  - Default rates could rise to 15% or even 20% with spillover into the credit market and stress on banks' balance sheets
- **Sovereign debt crisis**
  - Public debt will rise as a share of GDP across most countries in the coming years, starting from already high levels in Europe, Japan and the United States. This could lead to rating downgrades and rising interest rates over the long term
  - Emerging market fragilities (single commodity exporters, tourism), could also face a balance of payment crisis and increase default risks
  - Risks incurred in implementing the European Recovery Fund should not be underestimated. Dissensions among EU members could bring back EZ periphery bond risk

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

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

(GEO)POLITICAL RISK 15%

- **Contested US elections**
  - President Trump campaign is gaining momentum and the race with Joe Biden should be very close
  - The post voting process is already under scrutiny and the outcome won't be clear on Election Day.
  - A legal dispute over the results could drag on for weeks
  - Although it's unlikely there won't be a President for Inauguration Day, the political uncertainty could climax end November early December
- **US / China tensions**
  - The US elections campaign exacerbates tensions with China
  - The equally hawkish tone from Democratic Party brings new policy uncertainties to the bilateral relationship in a Biden-win scenario
  - Possible accidental confrontations in the South China Sea or the Taiwan Strait
- **No-deal Brexit**
  - The latest developments show that the probability of a no-deal exit on 31st Dec has risen dramatically
  - The new UK legislation which over-rules key parts of the Withdrawal Agreement on the highly sensitive Northern Ireland protocol further increased tensions with the EU
  - With only 3 months left and several hot topics still unsettled, the chances of an economic shock in Europe are high
- **Instability within and among EM countries**

+ **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 recovery in private sector business activity continues despite moderating significantly due to increasing uncertainty surrounding the pandemic.
- The manufacturing sector leads the recovery, as firms report strengthening demand and improving operating conditions.
- The service sector remains severely disrupted by the pandemic. The restrictive measures implemented to tackle the spread of the virus, are intensifying divergences across business sectors.
- The recovery remains mostly domestically driven, with, however, evident signs of improving export flows globally.

FUNDAMENTALS & VALUATION

- **Risky assets look less expensive after the recent pullback.**
- Equities' absolute PEs are still higher than their historical average even considering high 2021 EPS expectations. The equity risk premium and PE adjusted for CB liquidity injections favour equities in terms of relative value.
- So far, CBs have prevented any significant market correction since April, providing strong support to risky assets.

DEFENSIVE ASSET ALLOCATION

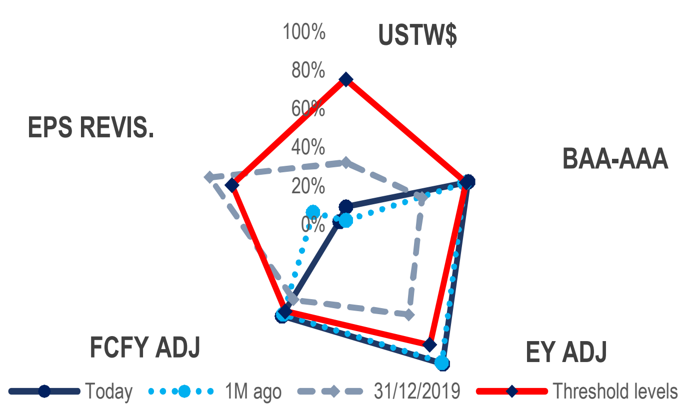
TECHNICALS

- Technical signals have strongly supported the first leg of the rebound in risky assets since March.
- Momentum, the strongest market mover since the summer, turned out less supportive this month. Seasonality, US election risk and a potential second round of restrictions have weighed on risky assets since the beginning of September.
- From a contrarian standpoint, markets are not overstretched any more though, as the recent sell-off has normalised the picture.
- Technicals remain thus overall neutral, as trend following signals and contrarian indicators compensate each other

SENTIMENT

- CAST remains the strongest contributor. EPS revisions have rebounded, and the USD depreciation has added support. The credit risk premium (Moody's BAA-AAA) remains around the alert threshold, but it's not enough to offset the call.
- Financial conditions eased further over the summer, as central banks pushed appetite for spreads products higher.
- Cross asset flows (based on State Street data) confirm the mild pro-risk stance. Although appetite for high beta and cyclical segments moved lower in September, the overall flows scorecard remain in neutral+ territory.

Cross Asset Sentinels Thresholds (CAST) still supportive



Amundi Research, Data as of 23 September 2020

CAST flags extremely low risk perception.

Sentinels remain in pro risk territory due to a general improvement in all the 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 Assessing the recovery

- With the peak of the pandemic now behind us in most of the major global economies (although secondary waves need to be watched), attention now turns to the speed and composition of the recovery.
- High-frequency data suggests a technical recovery, with Europe leading, whilst the US and UK are lagging behind.
- New evidence confirms our take that this is not the V-shaped rebound priced in by the markets.
- We maintain our view that we are facing a long U-shaped recovery, and that it will be late 2021 / early 2022 before global GDP recovers to pre-Covid-19 levels. Even in this scenario, emerging economies recover more quickly (basically a China story) than advanced economies (H2 22).

2 Preference for equities in our tactical and strategic allocation

- Q3 technical rebound doesn't move economies back to pre-Covid levels. Economic performance will progress along a slow upward sloping catch-up process. We expect the inflation trend to be up and to stabilise around targets in the forecast horizon. US companies' resilience underpin the ongoing profit recovery in US.
- We therefore confirm the recovery phase as the most likely macro-financial regime in the next 12 months. Still, we maintain a 20% probability for the downside scenario. Near-term risks are tilted to the downside, but in our medium-term radar we see a rotation from credit (HY) to equity.
- Tactical (1 month): Neutral+ exposure to equity and constructive for IG EU (contributing to a long duration). Long gold.
- Strategic View (3 to 6 months): rotation from credit HY into equity. Long gold.

3 Euro's "risk-on" status

- Market participants pushed the EUR higher and the single currency has confirmed its status as a 'risk-on' currency.
- If this trend continues it will become an issue for the ECB, which "carefully monitors developments in the exchange rate, with regard to its implications for the medium-term inflation outlook".
- Looking ahead, we expect an expansion of the ECB's asset purchases via PEPP/APP, rather than further rate cuts, which still seem highly controversial.
- The EUR/USD should therefore be range-bound or maintain its mild upward slope.

4 Politics will be the main market driver till year-end

- Policies are shaping the recovery trajectory and influencing market participants' narratives.
- If financial conditions remain as easy as they are, the Fed is unlikely to provide any further easing; nor will other key central banks. As such, markets will be left with economic data and politics, US fiscal stimulus, US elections, Brexit, and, obviously, Covid-19-related news.
- US fiscal policy is still in politically awkward damage containment mode. Unilateral Trump decisions (jobless benefits and eviction moratoriums) have temporarily forestalled the fiscal cliff. But we have little visibility on the Phase 4 bipartisan deal, and the recovery / reconstruction plan will be decided after the election.
- US elections are too close to call in the White House and Senate, though the HoR will probably remain Democratic. The markets' preference between Trump and Biden remains unclear.

US elections: a very close race*

Joe Biden is enjoying a 7pt lead in the national polls. However, the race will be very close, and the outcome remains uncertain for various reasons: (1) while Biden's lead in the national polls is significant, his lead in the swing states is only 3.9% and within the margin of error in many states; (2) we expect a record turnout, with the highest number on record voting by mail; and (3) the public has a net negative approval rating for Trump, but he enjoys a positive net approval rating on his handling of the economy, which could help if the economy gains momentum.

There are three main themes in Trump's campaign: law and order, China, and Biden's fitness for office. Biden is campaigning on economic policy ("Build Back Better"), healthcare, racial justice and morality. Biden is planning another fiscal stimulus package to address economic issues tied to the pandemic. Also, he has plans for a major infrastructure investment and backing (Green New Deal). Biden plans to boost Obamacare and prescription drug reform. Both candidates would have to deal with the long-term issue of rising inequality.

Investment implications: The dollar should stay weak in the medium term, due to the re-emergence of twin deficits and an escalating debt/GDP ratio, together with the Fed's long-term commitment to near-zero rates. The greatest risk to short-term market dynamics is an undecided race. Big tech, defence, financials and carbon energy sectors would be likely to perform better under Trump, while renewable energy and infrastructure-related sectors would be winners under Biden.

* Please read more: ***US presidential election: how it will impact US economy and financial markets***

AMUNDI ASSET CLASS VIEWS

	Asset Class	View	1M change	Rationale
EQUITY PLATFORM	US	-/=		US equity risky premiums vs bonds are still supportive of equity prices, although valuations divergence in some pockets of the markets such as between big 5 mega caps and rest of the markets is extreme. This calls for a balanced positioning across sectors as the recent correction reminded investors about the US elections risks and the still prevailing risks of a virus resurgence. Investors could focus on the leadership rotation towards cyclical and high quality stocks.
EQUITY PLATFORM	Europe	=		The economic data improved but the second wave of virus in the France, Spain, the UK and other countries has increased the risks as governments balance the need to impose strict lockdowns with boosting consumption. However, Q2 earnings were better-than-expected, and we believe, valuation dispersion is still high. This presents an environment where investors should be active, focus on resilient businesses and remain cautious overall.
EQUITY PLATFORM	Japan	=		Better global growth prospects should favour cyclical and export oriented markets such as Japan. While the new PM is likely to continue the economic support provided by the previous administration, investors should stay watchful.
EQUITY PLATFORM	Emerging markets	=		Emerging markets such as China, Korea have been better able to handle the crisis and this is reflected in economic data coming out of EM Asia, which confirms our first-in, first-out story. However, geopolitical risks related to China's more assertive foreign policy must be monitored. At a sector level, we are selectively exploring names in industrials, consumer discretionary and materials, and focusing on lower valuation name in technology.
FIXED INCOME PLATFORM	US govies	=/+		In global fixed income, we keep a positive view on US duration, although we believe this has to be carefully monitored in light of the recent Fed comments on inflation. In US fixed income, we prefer TIPS to UST.
FIXED INCOME PLATFORM	US IG Corporate	=/+		IG markets should remain supported by central bank support, however, investors should not compromise on sector and name selectivity. Investors should also look to pare back some duration risk and maintain appropriate liquidity buffers.
FIXED INCOME PLATFORM	US HY Corporate	-/=		We are cautious/neutral on HY as we believe the markets will remain supported by CB actions, but investors should be careful of defaults particularly in sectors such as tourism, energy which are most exposed to the crisis. In addition, a slow recovery could cause weak companies to struggle amid low business activity. The case for selectivity remains high.
FIXED INCOME PLATFORM	European govies	-/=		We find opportunities in this space in curve flattening amid low inflation in the Eurozone. On peripheral debt, we stay positive in light of continued ECB support and reducing risks of fragmentation with the rest of the European markets.
FIXED INCOME PLATFORM	Euro IG Corporate	++		We stay constructive on EUR IG as continued ECB support and lower leverage vs the US counterparts is positive for the asset class. Financials and subordinated debt remain our top pick, but selection is also important.
FIXED INCOME PLATFORM	Euro HY Corporate	=		We prefer the high-rated BB segment in HY because we believe investors should not go too low in the credit quality spectrum for that extra yield. There could be increasing fragmentation between companies with sufficient cash buffers vs those that struggle to meet day-to-day requirements due to lack of business activity. Therefore, selectivity is crucial.
FIXED INCOME PLATFORM	EM Bonds HC	=/+		We maintain our preference for Hard Currency debt, particularly in HY as IG spreads have already tightened to pre-covid levels, and the prospect of new supply lingers. However, risks of sovereign defaults should be monitored.
FIXED INCOME PLATFORM	EM Bonds LC	=		We remain cautious in EM rates overall. On FX, we see selective opportunities in currencies that we believe have underperformed and where there is room for a catch-up.
OTHER	Commodities			Commodities should benefit from expectations of economic recovery and availability of a vaccine. Going forward, oil demand may recover from the current subdued levels but we expect WTI price to stay between $40 and $50 per barrel over the coming few months. In precious metals, the recent sell-off in gold and silver was due to concerns over high real rates, worries about "risk-on" and a pause in asset buying by the Fed. Importantly, CB policies have been driving-up the gold prices and, as long as this accommodative stance is maintained, any painful sell-off is unlikely. However, if CBs unexpectedly change their stance, gold may be vulnerable to a serious de-rating, given that its fair value, based on traditional metrics (rates and FX), is much lower from current levels.
OTHER	Currencies			Structural and cyclical support for the USD is fading and this suggests that the greenback can continue to trend lower in 2021. Unlike the past when the USD kept on deviating from its fair value, now the USD has lost two of the main cyclical supports – the rate advantage and the US growth premium collapsed in H1 2020. However, we believe there are still short-term risks that will prevent a linear movement. In fact, correlation with risky assets stays high and some currencies (GBP, EUR above all) are still attached to the risk of disappointment in growth expectations.

LEGEND

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Negative | Neutral | Positive | Downgrade vs previous month | Upgraded vs previous month

Source: Amundi, as of 30 September 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. 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.

Amundi ASSET MANAGEMENT | Research

CROSS ASSET
INVESTMENT STRATEGY

October 2020 #10

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