CENTRAL & ALTERNATIVE SCENARIOS (12 TO 18 MONTHS HORIZON)

Monthly update

We maintain the probabilities of our scenarios unchanged. Some of the risk factors we identify may occur in our central scenario, which is probably not yet fully priced-in by markets. Risks remain skewed to the downside in the short term, but it would take a combination of several risk factors to trigger the downside scenario at the 12-18 month horizon. At this horizon, we believe that the downside is counterbalanced by an upside scenario, that of a rapid decline in inflation due to an easing of gas prices, a ceasefire in Ukraine, and/or to the combined tightening of global monetary policies, the impact of which can be underestimated.

DOWNSIDE SCENARIO 15%

Deep global slump

Analysis

- Worsening/expanding **war in Ukraine.**
- Energy crisis and **deep recession in Europe.**
- **Covid-19 resurgence.**
- **De-anchoring of inflation expectations,** CB lose control.
- **Recession in China.**
- **Global economic downturn** with, in a second stage, renewed deflationary pressures.
- **Global financial crisis/debt crisis with several EM defaults.**
- **Governments can no longer implement countercyclical fiscal policies.** Recession paves the way for financial repression.
- **Climate transition measures postponed.**

Market implications

- Favour cash, USD and US Treasuries.
- Play minimum-volatility strategies.
- Gold.

CENTRAL SCENARIO 70%

A stagflationary episode, with rising divergences

Analysis

- **Stalemate in the Ukraine war.** We expect a ceasefire at some point in 2023; in the meantime, the situation may deteriorate further.
- **Energy crisis here to stay.** Gas prices expected to rise in the restocking phase, with no credible cap in the EU.
- **Covid-19** is an endemic disease.
- **Inflation fails** to return to CB target by 2024.
- **Deep global economic slowdown in 2023:** recession in Europe and rising recession risks in the United States and China. Modest expansion and sub-par growth expected in 2024.
- Global **nominal GDP to trend higher,** mitigating the impact on earnings.
- **CB divergences:** Fed to continue to normalise, but reduce the size of hikes; ECB to raise rates, adopt a passive QT, and activate the TPI; PBoC on an easing bias.
- **The policy mix is inconsistent across the EU:** accommodative fiscal policies, but uncoordinated and not well targeted. Conversely, the fiscal impulse was negative in the United States in 2022, but is expected to be more neutral 2023-24.
- **Climate change** disrupts the commodity cycle and adds to stagflationary trends.

Market implications

- Lower risk-adjusted real returns expected.
- Contained steepening of yield curve, govies regain their function of hedging against a deeper recession.
- Inflation hedge via gold, linkers, equities, real assets and commodities.
- EM: short-term caution, long-term real income and growth story intact.

UPSIDE SCENARIO 15%

Inflation falls back quickly, ending the stagflationary episode

Analysis

- **Ceasefire in Ukraine paving the way for peace talks.**
- **Russia partially resumes gas exports to Europe,** commodity market normalises.
- **Covid-19** recedes.
- **Inflation falls back quickly,** supply bottlenecks ease.
- **Global recession fears** dissipate and inflation gradually returns to more normal levels, easing pressure on CB.
- **Lower uncertainty,** extra savings and renewed purchasing power can fuel consumption and investment in DM.
- **Fiscal discipline** gradually restored. In Europe, a new plan (common debt) is put in place to address the changing energy mix.
- **Climate change** policies and energy transitions become first priority.

Market implications

- US Treasury curve to bear steepen.
- Favour risky assets with cyclical and value exposure.
- USD depreciation.
- Favour linkers and equities as an inflation hedge.

Geopolitic | *Covid-19 related topics* | *Growth and inflation expectations* | *Monetary and fiscal policy* | *Recovery plans or financial conditions* | *Solvency of private and public issuers* | *Economic or financial regime* | *Social or climate related topics*

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TOP RISKS

Monthly update

We keep the probabilities unchanged for the three families of risks. We see risks growing on all fronts, closely linked to each other. Economic fundamentals are deteriorating globally, which is reflected in the central scenario. The course of the Ukraine war and its potential implications can tip the scenario in either direction, but risks are tilted to the downside in the short term. We consider Covid-19-related risks (including lockdowns in China) as part of the economic risks. Risks are clustered to ease the detection of hedging strategies, but they are obviously related.

ECONOMIC RISK 30%

— **Global recession** driven by an oil/gas shock, tightening monetary conditions, and a loss of purchasing power.

— **The *weaponisation* of gas supply** by Russians could cause a **severe energy crisis in Europe,** leading to a **deep recession** (confidence shock).

— **Economic crisis in Eastern Europe** following a collapse of the Russian economy, elevated energy prices, uncontrolled inflation, and a migrant crisis.

— **Disordered CB adjustments**, which underestimate inflationary pressure and lose control.

— **Global profit recession** triggered by the global slowdown, coupled with persistent input-cost pressures.

— **Recession in China.** Zero Covid-19 policy combined with a housing crisis spiralling out of control.

— **End of the great coincidence:** with stagflationary pressure, CB and governments' goals are no longer fully aligned: the room for countercyclical fiscal policies is reduced.

— **Europe:** inconsistency in the policy mix (accommodative fiscal stance coupled with restrictive monetary policy)

— **Pandemic:**
- Risk of a more dangerous and vaccine-resistant variant.
- New lockdowns or mobility restrictions.

— **Climate change**-related natural events hurt growth visibility and social balance.

+ Cash, linkers, JPY, Gold, USD, Quality vs. Growth, Defensive vs. Cyclicals.

- Risky assets, AUD CAD and NZD, EM local CCY.

FINANCIAL RISK 30%

— **Sovereign debt crisis:**
- An extended war in Ukraine would hurt DM vulnerable public finances with public debt ratios already at historic highs.
- De-anchoring inflation expectations could lead to harsher monetary tightening and to a bond market dislocation.
- Most countries are vulnerable to rating downgrades and rising interest rates.
- Weak EM could face a balance-of-payment crisis and increased default risks.

— **Corporate solvency risk increases,** amid deteriorating fundamentals, rising uncertainty, and corporate margins under pressure (high input cost, double orders lead to profit warnings).

— **Widespread greenwashing and ESG investment bubble undermine the energy transition funding.**

— **USD overshooting** leads to unstable currency markets.

— **Currency wars:** currency appreciation is a way for CBs to fight inflationary pressures.

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

- Oil, risky assets, frontier markets and EMs.

(GEO)POLITICAL RISK 30%

— **Ukraine war:**
- **Risks are titled to the downside.** There is a **60% likelihood** of a negative development of the war, including a **25% likelihood of direct confrontation with the West.** This risk grows the more Russia faces military defeats.
- Despite our expectation for the conflict to worsen in the meantime, **our base case is an end to hostilities 2023** (most likely H2) at **35%** likelihood.

— Following mid-term election, **the United States will focus on domestic political battles, which will heighten tensions with China,** as Republicans and Democrats compete for hawkishness, **contributing to growing the 'Taiwan' risk in 2023.**

— **EM political instability driven** by higher food and energy prices, leading to a wave of social unrest.

— Iran or Korea **nuclear programmes** renewed concerns and sanctions.

— **Cyber-attack or data compromise,** disrupting IT systems in security, energy, and health services is elevated as Russia seeks to undermine Western support to Ukraine.

+ DM Govies, Cash, Gold, USD, Volatility, Defensive, Oil.

- Credit and equity, EMBI.

CROSS ASSET DISPATCH: detecting markets turning points

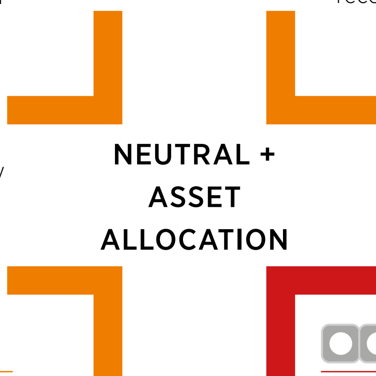
The turning point has occurred | Approaching the turning point | Not reached yet too early to call it

ECONOMIC BACKDROP

- Economic momentum is slowing amid persistently high inflationary pressures and weakening domestic demand. We confirm our expectations of a deteriorating US macro outlook on the back of progressively tighter financial conditions; recession risks remain prominent for mid-2023. For Europe, we confirm our expectations of a cost-of-living and inflation-driven recession during the upcoming winter season.
- Inflation-wise, we have seen the peak in the United States. We expect a progressive deceleration in both headline and core indices, although signs of greater-than-normal persistence remain. In the Eurozone, inflation may be close to peaking but is expected to remain near double digits and at stressful levels for some months to come.
- The prolonged stress on the geopolitical front and the tug-of-war between fiscal and monetary policy make the final economic outcome uncertain, exacerbating data volatility.

FUNDAMENTALS & VALUATION

- Stocks look more expensive after the recent rebound; it remains difficult to see any strong catalysts for entry points.
- Stock multiples look aligned with the current inflationary environment and tight monetary policy but are not yet discounting any recession risk. In relative value, considering high rates, they are not in favour of risky assets.
- Fundamentals deteriorated further; a profits recession is the central case.



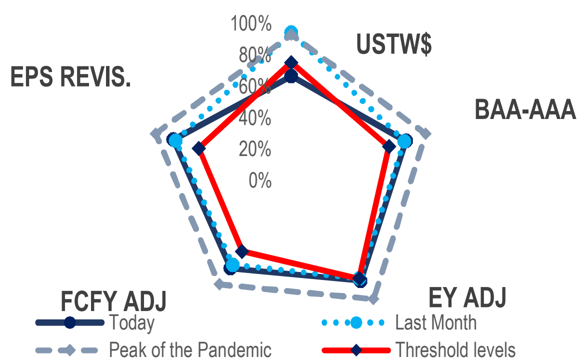
TECHNICALS

- Technicals remain highly volatile in the current market set up, yet strongly in support of risky assets for the month of November 2022. Our trend-following indicators continue to see value in being long risky assets, as most trends turned from fragmented to solid in late October. On the other hand, contrarian metrics, while far from sending out sell signals, have recovered substantially, thus calling for cautiousness towards yearend.

SENTIMENT

- Lower US inflationary pressures pushed back interest-rate volatility and financial conditions eased in response to that. Risk sentiment metrics remain fragile, but improved fast in November. Financial conditions remain tight, but eased substantially. The sharp USD sell-off has been feeding into our CAST model, which now sees a much lower risk-off probability than in October. MoMo is the only model already in risk-on mood, on the back of less-defensive investors flows and improving risk-sensitive short-term indicators.

Cross Asset Sentinels Thresholds (CAST) – The sell-off in the USD is the strong supportive factor in November. CAST defensiveness is moderating lower.



Source: Amundi Institute. Data as of 18 November 2022.

The CAST risk perception failed to show a structural increase in Q1 but has turned less favourable since Q2. EPS revisions remain negative and the credit risk premium remains high and above alert, yet the move in the USD is calling for a less defensive stance. CAST OFF probability is off its highs and entering a neutral zone.

Methodology: we consider five input variables, called 'sentinels': US trade-weighted dollar, Moody's Baa-Aaa spread, EPS revisions, adjusted earning yield risk, and adjusted cash flow yield risk. 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 any market stress conditions, with a certain level of conviction. The pentagon visualises the five sentinels, where the red line represents the alert threshold. The greater the distance above the red line, the greater the risk perception, and eventually the need to move closer to a defensive asset allocation.

AMUNDI INSTITUTE CLIPS

1 ECB concerned about recession risks

- At its October meeting, the ECB highlighted how the fight against inflation could get difficult as the economy is expected to enter a recession in late 2022, suggesting a less aggressive rate-hike path ahead.
- However, a dovish turn is not a given, as inflation remains uncomfortably high.
- We have cut our projection for the ECB terminal deposit rate to 2.50% from 2.75%.
- For all central banks, the challenge next year will be to maintain their credibility: any dovish surprise should be coupled with satisfactory progress in inflation towards target.

Investment consequences

- Twelve-month target for 10-year Bund yield unchanged at 2.3-2.5%.
- EUR/USD target also unchanged, at 0.92 in six months and 1.02 in 12 months.

2 Fed remains committed to fighting inflation

- The November Fed statement was dovish, but Chair Powell's press conference was hawkish, as the Fed did not want the market to interpret a possible reduction in the size of rate hikes as a dovish pivot or as a lack of commitment to fight inflation.
- We believe the Fed will find better risk-reward in overtightening, as it has the tools to support economic activity strongly if needed, as it showed during the pandemic.
- Focus should be on terminal rate and how long interest rates should stay in restrictive territory.
- We confirm our projection for the terminal Fed Funds rate at 5.25%.

Investment consequences

- Twelve-month target for ten-year US Treasury yield unchanged at 3.9-4.1%.

3 Inflation trends across DM

- US core inflation has been proving sticky, while headline inflation should weaken over the next few months, as gasoline prices should drop.
- US PPI dynamics have peaked and the CPI-PPI gap has been narrowing, although still above average; the transmission from lower PPI to lower CPI may be delayed, but signals are pointing in the right direction.
- Eurozone inflation – both headline and core – should peak in Q4 2022, but the upcoming wage negotiation rounds will be crucial, as they may reinforce inflation persistence.
- Eurozone inflation pressures remain strong and not completely passed through yet. PPI is sending out limited signals of moderation, and the CPI-PPI gap remains wide.

Investment consequences

- Confirm UW in equity.
- Core rates: confirm UW/neutral positioning on duration, rising real rates, flattening US yield curve.
- Peripheral rates: keep a cautious approach.
- Credit markets: US IG favoured over US HY.

4 Political and geopolitical update

- **US mid-term election:** Democrats performed better than expected, retaining control of the Senate, but losing the House. No big bills are likely to be passed over the next two years, while US-China tensions are likely to remain; more scrutiny is likely over funding to Ukraine.
- **UK fiscal budget:** It is aimed at regaining market trust, while supporting the key conservative voter base. However, more spending for 'levelling up' and increasing taxes on high income earners also highlights that the Conservatives are still targeting former Labour 'red wall' seats in left-behind areas that switched to the Tories at the last election, but have since been increasingly disgruntled with the party.
- **Brazil presidential election:** Lula won the second round. He appears keen to spend freely but may moderate his stance under further market pressure.

Investment consequences

- Markets enjoy divided governments, as populist policies get prevented.

5 China's structural slowdown already showing up

- Two sources are contributing to slower potential growth: a fast-aging population and declining return on capital.
- Full relaxation of Covid-19 curbs is unlikely until 2024.
- Housing market drag should recede in 2023.
- We have upgraded our 2022 growth outlook to 3.2% from 2.9%, due to better-than-expected Q3 data, but while cutting our 2023 projection to 4.5% from 5.2% on a dimmer Covid-19 policy outlook. 4.0% growth is achievable in the next three years, with a convergence then expected down to 3.0%.

Investment consequences

- Long HSCEI, add MSCI China and CSI 300 dividend.
- Credit: stay neutral, six-month/two-year HY is relatively cheap.
- Rates: move to neutral from short.
- Commodity: stay neutral.

6 Q3 earnings season: more negative, but not a collapse

- EPS downgrades and results were ahead of expectations. Despite beats, companies are reducing forward guidance.
- The growth slowdown and inflation impact show up in strong energy sector growth, which remains the key EPS driver. Ex-energy, US's Q3 EPS is -3.4% and Europe's is 9.6%.
- A few consumer sectors have been struggling and, especially in Europe, the real estate sector, as well.

Investment consequences

- Stay cautious on equity, while favouring the United States over Europe.
- Focus on quality, value, high dividend, and min vol.

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DISCLAIMER TO OUR FORECASTS

The uncertainty around the macro forecasts is very high, and it triggers frequent reassessments any time fresh high frequency data are available. Our macroeconomic forecasts at this point include a higher qualitative component, reducing the statistical accuracy and increasing the uncertainty through wider ranges around them.

METHODOLOGY

— Scenarios

The probabilities reflect the likelihood of financial regimes (central, downside and upside scenario) which are conditioned and defined by our macro-financial forecasts.

— Risks

The probabilities of risks are the outcome of an internal survey. Risks to monitor are clustered in three categories: Economic, Financial and (Geo)politics. While the three categories are interconnected, they have specific epicentres related to their three drivers. The weights (percentages) are the composition of highest impact scenarios derived by the quarterly survey run on the investment floor.

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