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

- After the strong expansion over the summer, economic growth rates are expected to remain solid, although moderating, as highlighted by the progressive stabilisation of high-frequency and soft data as economies head toward pre-Covid-19 levels. The consensus continues to adjust downward, while economic surprises remain negative despite some very moderate signs of a potential upward reversion.
- Economic activity in the US is expected to pick up in Q4 after the deceleration seen at the end of Q3, in line with gradual improvements in high-frequency and soft data. The CESI Index remains in negative territory, despite reverting progressively upward, supported by both hard and soft data releases. The consensus continues to trend downward, remaining, however, in positive territory.

FUNDAMENTALS & VALUATION

- Multiples and, in general, valuations will be tested by this reporting season, keeping in mind margin-squeeze concerns and forward guidance for next year. In general, most equities markets are in expensive territory and consistent with positive growth expectations. Should reporting season disappoint potential, repricing likely be the final outcome.
- CB liquidity injection remains a solid argument for the markets' high levels, although the start of tapering should erode investors' complacency.

NEUTRAL + ASSET ALLOCATION

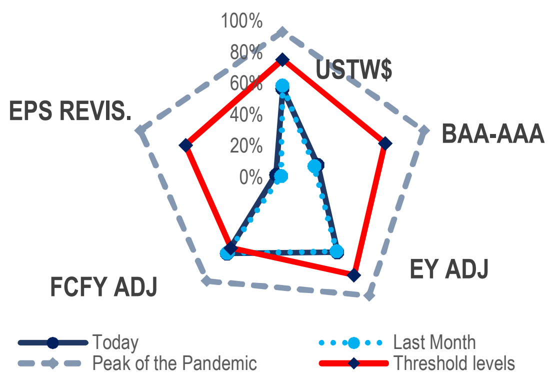
TECHNICALS

- We are still seeing the same mixed environment from last month.
- Contrarian metrics were showing that a few markets were approaching oversold levels (looking at RSIs) last month and the reading, whilst worsening, didn't change much in October. RSIs moved higher but remain pretty far from overbought levels.
- On the other hand, momentum is struggling to build up in most risky assets, and this seems to be a function of rising uncertainty and the low visibility over the next steps.
- Technicals remain mixed, with a lack of directional bias at the time of this writing.

SENTIMENT

- If, on the one hand, we acknowledge that nothing has improved much when dealing with growth perception, on the other we also continue to note that most of our risk sentiment metrics are still in pretty solid shape.
- Despite the mounting wall of worries, we are sticking with a moderately constructive risk sentiment in the market. Financial conditions remain loose in most regions, whilst EPS revisions, whilst worsening, are still compensating for both the USD and the drop in economic surprises (which are clearly showing early signals of risk-gyration).
- Institutional investors continue to show a positive risk-attitude, with risk-on dynamics still apparent in equities and commodities.

Cross Asset Sentinels Thresholds (CAST) still supportive



Source: Amundi Research, Data as of 15 October 2021

CAST risk perception failed to show a structural increase. EPS revisions started moderating (reducing the gap with negative data surprises) but CBs are still keeping credit risk premia low and the USD momentum softened on the margin. All in all we are lacking evidences of structural de-risking, yet visibility on the next steps keeps deteriorating.

<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 The energy crisis should be temporary

- Natural gas prices have surged, contributing to global resource inflation.
- China and Europe are seeing the largest demand/production imbalance.
- Despite the rally, natural gas prices are not out of control, and, as the world is expected to ultimately be in net surplus, natural gas flows will rebalance imports in Europe and Asia.

Investment consequences:

- Central case: no power crunch this winter in European and Chinese energy, but pressure persisting.

2 China's growth forecast downgraded and impact on EM countries

- Weaker than expected Q3 GDP, more negative than positive catalysts on a six-month horizon.
- We are downgrading our growth forecasts again, no longer expecting growth to recover to trend in Q4 2021, due to the housing slowdown and the decarbonisation production cuts.
- CPI inflationary pressures remain subdued as services consumption has been hit hard by the Covid zero-tolerance policy.

Investment consequences:

- Slowdown in China to affect Chile and Peru the most via trade and commodity exports.

3 EM short- and medium-term economic backdrop update

- Economic momentum tracked by CEMI deteriorated more than expected, driven by GEM component (specifically China).
- Inflation looks more persistent, putting pressure on monetary policy and nominal (and real) rates.
- Medium-/long-term: atypical normalisation: growth to potential and inflation at last-decade highs.

Investment consequences:

- In the short term, this is a less benign environment for valuation in risky assets, which markets have not yet priced in, despite the recent pullback.

4 G10 FX in a narrow range

- Most of our year-end targets were reached in September 2021, with cyclical currencies hitting lower levels than what we previously expected.
- Main FX themes currently:

  1) Monetary policy divergence calling for high vs low yielders.

  2) Slowing global growth suggesting carry would need to be of the highest quality (i.e., the USD).

  3) Risk-on, risk-off dynamics would likely accelerate the moves.

  4) Lack of clear-cut directionality.

Investment consequences:

- G10 FX to trade in narrow ranges, due to a lack of clear-cut directionality, with the USD benefitting vs low yielders and stabilising against most cyclical currencies.

Covid-19 situation update

Pierre BLANCHET, *Head of Investment Intelligence*

As we enter the winter season in the northern hemisphere, the rising number of Covid cases is reviving fears of a new wave. China is witnessing a resurgence of the outbreak, despite its mass vaccination campaign, albeit with a less effective vaccine. In western Europe, several countries including France and Germany are seeing an increase in weekly cases, although the level of Covid-related deaths is still limited. The UK is an outlier with three times more cases than on the Continent and eight times more casualties. But the main concern relates to Central and Eastern Europe, where the vaccination rate remains low and the infection and death rates are among the highest in the world. In Romania, Bulgaria and Moldavia, which are at the heart of this new wave, the number of daily deaths per one million inhabitants is 10 to 15 times greater than in the West. A lack of trust in authorities, inefficient public health structures and political instability explain the low vaccination rate (20-30% on average) which translates into a high death rate. Across emerging countries, the Covax programme backed by the WHO has not (yet) provided enough vaccines to limit the circulation of the virus, which means we could see the emergence of more virulent strains with far reaching consequences for advanced economies.

AMUNDI ASSET CLASS VIEWS

Platform	Asset Class	View	1M change	Rationale
EQUITY PLATFORM	US	=		After the Fed's taper update in late September, inflation expectations and bond yields gained strength and the reopening trade reasserted its relative performance. However, strong inflation data necessitates that investors protect their portfolios from rising prices and volatility from debt ceiling and tax hikes should also be kept in mind. While remaining overall neutral on equities, we believe investors should increase their focus on fundamentals as valuations remain high.
EQUITY PLATFORM	US value	+		The recent rise in core yields has been accompanied by escalating inflation. We believe value (financials, energy) is a strong way to inflation-proof portfolios, particularly in the case of quality companies that possess strong pricing power. The value vs. growth discount is high but long-term returns in this realm will be driven more by stock selection.
EQUITY PLATFORM	US growth	-		We think current valuations are inconsistent with expectations of high inflation and subsequently higher (real) rates, which could challenge excessive valuations. As we progress on this front, growth stocks that rely on low discount rates for their prices should experience volatility, thereby warranting a defensive stance.
EQUITY PLATFORM	Europe	=		Amid a spike in energy prices, economic recovery continues in Europe but valuations are extreme in some segments and are not justified by high inflation, which pressures companies to absorb costs, thereby affecting margins. However, amid the high valuation dispersion, investors should prioritise selection and explore value and quality stocks that can withstand price pressures through strong pricing power or a dominant market position beyond the current earning season.
EQUITY PLATFORM	Japan	=		Given that Japan is a more cyclical market, equities should remain supported by an earnings catch-up as new Covid cases recede and as the reopening continues. A weaker yen should further support this.
EQUITY PLATFORM	Emerging markets	=		We believe the case for selection is high in EM and it should no longer be seen as 'one block.' Looking ahead, normalisation of earnings and progress on the vaccination front paint an encouraging picture for EM, but there are some idiosyncratic risks. On China, some weakness in growth and potential regulatory measures make us cautious in the near term, but the long-term outlook is positive as the country embarks on more balanced and high-quality growth. We like countries such as Russia due to its strong exports, and India owing to its potential for domestic demand.
FIXED INCOME PLATFORM	US govies	-		Core yields have been rising after comments from the September FOMC meeting amid the Fed's tapering indications. But inflation remains elevated even as supply constraints persist. We believe USTs could be under pressure, but the risks of inflation derailing a recovery mean CBs may be unwilling to implement substantial tightening. As a result, we are cautious on duration but remain flexible. TIPS offer inflation-protected returns but there are valuation concerns.
FIXED INCOME PLATFORM	US IG corporate	=		Credit fundamentals are constructive but we are exploring the asset class through a highly selective lens that allows us to limit our beta and exposure to long duration debt. We are also watchful of the risks from rising core yields at the moment. Securitised credit and mortgages are attractive due to high consumer earnings and savings, but we are vigilant on housing markets amid the Fed's potential tapering.
FIXED INCOME PLATFORM	US HY corporate	=		We are moving towards a phase where market directionality will play a decreasing role in driving returns. Although the segment offers good carry and fundamentals are benign, we are increasingly relying on selection to separate the wheat from the chaff and avoid highly leveraged areas.
FIXED INCOME PLATFORM	European govies	-/=		Inflation is high amid supply bottlenecks and pressures from the energy situation, which is collectively reflected in rising yields. While the ECB indicated some slowing in asset buying, we believe it will strive to maintain accommodative financial conditions. Thus, we remain defensive and agile on core and semi-core European government bonds. On periphery debt, however, we are positive due to the recovery and support from the Next Gen EU fund, but are monitoring political risks.
FIXED INCOME PLATFORM	Euro IG corporate	=/+		Fundamentals continue to improve, albeit at a slightly slower pace, and liquidity remains high. However, we increase the selectivity in our portfolios to look for companies that can pass on the increase in costs to consumers. We like shorter maturity debt and BBB-rated names, but avoid higher rated names that may engage in unproductive M&A or add debt.
FIXED INCOME PLATFORM	Euro HY corporate	=		We believe this is not a time for structural derisking but are careful of longer-dated debt and prefer playing the spread compression card. Subordinated financial debt presents a strong theme across credit with its attractive yield, but overall we maintain a balance between higher yield and quality.
FIXED INCOME PLATFORM	EM bonds HC	=/+		Improving current account balances and the EM growth differential vs. DM are positives. We continue to favour HC debt and maintain our bias towards HY vs. IG in countries benefitting from strong fundamentals and higher commodity prices.
FIXED INCOME PLATFORM	EM bonds LC	=		A strengthening dollar in the near term and potential tightening in the developed world are a natural challenge for LC, underscoring the need to be selective. We focus on countries such as Russia, where monetary tightening is almost over. In Asia, the PBoC will strive to avoid any spillover to other parts of the economy.
OTHER	Commodities			While natural gas prices have increased due to demand/supply imbalances in Europe and Asia, they are not out of control. In the long run, the world is expected to be in net surplus. OPEC should increase oil production in order to avoid a hit to global demand. However, gold could see some volatility (Fed policy normalisation) but is still a decent portfolio diversifier.
OTHER	Currencies			Monetary policy divergences and slowing global growth should be positive for the USD (high quality carry) vs. low yielding FX such as the EUR, CHF and JPY. However, relative to high yielding cyclical currencies, the USD should stabilise. Long term, high US deficits and debt are likely to weigh on the greenback.

LEGEND

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Negative			Neutral	Positive			Downgrade vs previous month	Upgraded vs previous month

Source: Amundi, as of 26 October 2021, 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.

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