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PENSION FUNDS LETTER

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Confidence must be earned

Amundi ASSET MANAGEMENT

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EXECUTIVE SUMMARY

Resilience is all

Today, investors have a unique opportunity to observe the spreading of a real virus alongside the viral nature of financial markets and the real economy. As Nobel Prize-winning economist Robert Shiller points out in his book, *"Narrative Economics: How Stories Go Viral and Drive Major Economic Events"*, stories and images are created around new economic events[1]. In some cases, these stories are memories of the past and their spreading can have major implications regarding performances of economies and financial markets.

Two conflicting narratives are now playing in the markets: one positive (election of Joe Biden, news of a vaccine becoming available soon) and one negative (pandemic second wave and its negative economic consequences). In that context, pension funds may follow interest rates movements: they will lead the narrative path and drive investors towards possible changes.

As the situation becomes clearer over time, pension funds will be dealing with how to build resilient portfolios. But what does resilience mean in the context of a deep recession which turned investment returns into a monetary phenomenon? The Amundi-Create 2020 survey provides some answers. It means targeting backstops or inbuilt shock absorbers or both. It implies selecting firms that can weather the storm and emerge stronger. Scenario planning and liquidity management are the necessary tools to navigate resilient asset allocation. Pension funds goals in that area will reinforce the alpha–beta separation, as fees become a key source of returns. Indeed, equities will retain their gravitational pull while passive funds will continue their ascent by tilting towards megatrends.

Analysis is also changing. Pension funds may now look to the future rather than the past. The "factoring future into the present" process has enabled ESG funds to shine in the pandemic context. Their resilience owes more to stock selection than sector bets. They have reminded pension investors that the success of ESG rests on a 'just transition' to a low-carbon future, unlike globalisation.

The implied green evangelism underscores another core message: the old shareholder primacy model can no longer be relied upon to create sustainable economies that will deliver affordable pensions to millions in an interconnected world where negative fat tailed events are no longer a rarity.

This shift in mindset marks a defining moment.

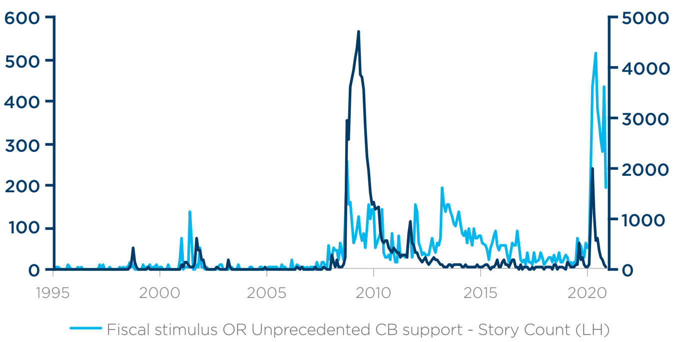
1. In the words of Shiller, narrative economics is: "a theory of economic change that introduces an important new element to usual list of economic factors driving the economy: contagious popular stories that spread through word of mouth, the news media, and social media".

Pascal BLANQUÉ
Group Chief Investment Officer

Conflicting narratives in the markets: interest rates hold the key

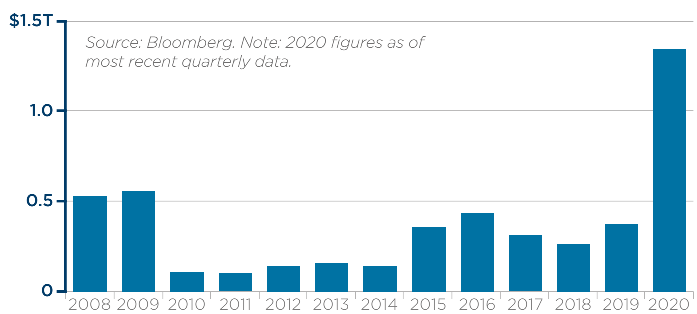
Markets tend to focus on the actions of policymakers. Hence, the extreme monetary and fiscal measures to address the effects of the Covid-19 outbreak have led to a new picture of a 'day after' renaissance, based on memories of the previous successes of Central Banks in fighting the Great Financial Crisis. When looking at the stories circulating among market participants (using Bloomberg stories as a source), the unprecedented size of the monetary and fiscal stimuli has been outpacing memories of the global economic damage induced by the pandemic and markets have started to price in the rosiest scenario.

The fiscal and montetary narrative outpaced the global recession fear



Source: Amundi analysis on Bloomberg, data as of 20 November 2020.

Rise of the Zombies The debt load of companies without enough operating income to cover interest expenses has soared during the pandemic



However, the road towards recovery could be bumpy and two conflicting narratives are currently circulating in the market.

On the one hand, the second wave of the pandemic will induce a new economic slowdown, affecting Europe in particular. The credit cycle has been affected and defaults should follow. So far, only those companies most directly affected by lockdown measures have gone bankrupt, but the zombie companies[1] phenomenon is expanding exponentially.

The trade-off between solvency and liquidity continues. There are likely to be more victims, and many downgrades are still to come. Expectations that the pandemic is over may be too optimistic, and any slip-ups cause the markets to heat up again. Although some risk assets are back to pre-Covid-19 levels, in general, the situation is more fragile. The overall debt in the system is higher; younger generations will have to pay for it. There is a wider gap between performance and valuation for high tech/digital companies and the rest of the market. Some sectors are very unlikely to recover to pre-crisis levels. Higher unemployment and rising social inequalities are risks to consider going forward, when the support of temporary fiscal measures will fade.

While governments and central banks have introduced extreme measures, more will be needed to sustain current market valuations and avoid further economic fallout. Some risk assets (especially crowded trades) are currently priced for perfection, and there is no room for disappointment. Moreover, the risk of policy mistakes cannot be underestimated: any premature withdrawal of fiscal measures would damage the nascent recovery.

On the positive side, there is the outcome of the US election. The market reaction to the outcome of a potentially divided Congress was positive. A Republican-controlled Senate will mean the incoming Biden administration will be hamstrung with regard to passing a large fiscal stimulus package, a big infrastructure bill, and higher taxes. This could help contain the budget deficit. However, concerns about the outlook for growth next year without a large amount of fiscal stimulus could be mitigated by very positive news from Pfizer and Moderna on the high efficacy of their vaccines. Markets have already started to anticipate a sort of "back to normal", although the macro news flow remains negative.

The two conflicting narratives are still in the market, with the most positive one prevailing. There is a key element in this narrative that is crucial, in our view: the direction of interest rates. They hold the key for investments in the coming quarters.

A risk assets rally is based on the mantra that core bond yields will stay anchored forever, but this belief may prove more fragile than previously thought. This could have a significant impact on markets and in particular areas where crowded trades have been building up recently.

The assumptions on rates translated into an over-large exposure to the 'long duration call' that is implicit in different trades - not only the direct long US Treasury trade, but also in long investment-grade credit, long Big Tech equities, long private equity or real estate. In the end, they are all trades playing the same long duration view.

The Fed's unlimited QE has pushed UST yields to all-time lows. The bank's new framework of "average inflation target" means short-term rates should stay pinned near zero during the recovery phase, but this doesn't imply that the long end of the curve cannot adjust to improving fundamentals, especially should the vaccine accelerates a normalisation of economic conditions and put some precautionary saving back into consumption.

The implication is that the US Treasury will likely steepen in the 2s10s or 10s30s segments. Some steepening has already started to materialise, but we could even reach a point when the steepness of this cycle could be greater, since the Fed and the ECB aren't going to hike until inflation moves way above their targets for long periods of time. This would not only have an impact on the bond market. This is also relevant in the context of current high market valuations, especially in the tech sector. These valuations are acceptable if interest rates remain low forever or fall further. Any increase in interest rates for various reasons (higher prices as a consequence of supply chain disruption, the news of a vaccine becoming available which would normalise economic activity, or the reduced absorption of huge US debt issuance by the Fed) could drive **a repricing of assets. This would support a rotation out of high-growth stocks towards quality value and cyclical sectors.**

New possible narratives for the long term

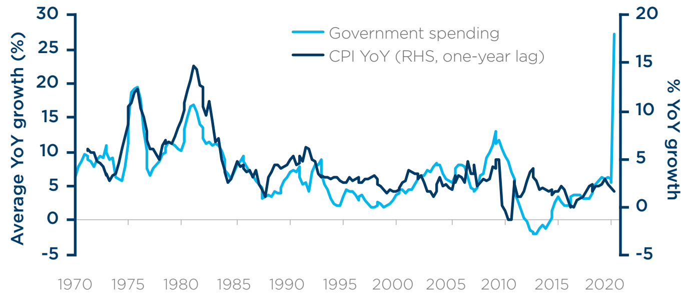
On a long-term view, the battle between the images generated at different levels (public and institutional) and the evolving political landscape could end eventually with a new financial regime. The '70s vs '30s opposition is the conflict that will drive the new regime. As has happened in the past, political forces will be key in driving the new order. We expect de-globalisation dynamics to be further reinforced in the post-Covid19 world (with re-insourcing of value chains and control of strategic assets by governments), with inequality and social themes emerging even more prominently and climate change becoming in greater focus (see also our previous 'the day after' papers).

Tackling post-Covid 19 challenges will require further debt expansion to finance all of the investment that is needed to drive change that benefits society in a broad manner. This will require inflation to return and real rates to remain low to allow for the repayment of debt.

Today, the inflation topic is completely off the radar among market participants (see the lack of Bloomberg stories on the topic, next column).

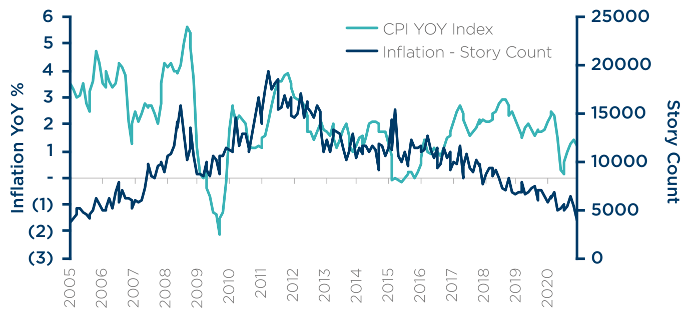
1. Zombies are companies that earn just enough money to continue operating and service debt but are unable to pay off their debt.

US fiscal spending and annual CPI



Source: Amundi analysis on Bloomberg, data as of 20 November 2020.

Markets narratives still ignoring inflation



Source: Amundi analysis on Bloomberg, data as of 20 November 2020.

At the public opinion level, attention to food price dynamics and minimum salaries had already been rising over the last few years and could come increasingly into focus amid possible price increases due to value chain disruptions related to the pandemic (see Inflation paper in 'the day after' series). **Eventually, a new narrative of higher inflation might start to emerge and a new order might take a shape similar to that seen in the 1970s** (as deglobalisation comes with monetisation of debt). The shift in narratives and regime shifts are arguably the only sequence during which investors can systematically extract value, as the remaining times they would be faced with more efficient markets that would not allow them to do this. The 'Efficient Market Hypothesis' works on the assumption of there being some market equilibrium.

In this adjustment process, investors should avoid strict asset allocation guidelines and keep a high level of flexibility and liquidity to exploit the opportunities arising from inefficiencies and dislocations. The ability to identify the early signs and patterns of these shifts is critical. Big data and artificial intelligence are therefore likely to become even more relevant in the investment world, as they open up the possibility of tracking these patterns and using them to better understand and forecast trends. Regarding inflation, for example, with visibility around the structural Covid-19 spill-overs being scarce and considering the limited hard data available, investors should look for innovative research techniques in big data, using high-frequency indicators that could provide insights that capture early changes and anticipate trends. To be clear: inflation is not an imminent risk. The crisis is first deflationary in nature, but the sequence matters, and investors should start looking at these themes **today**, to evaluate possible hedging or strategies to address the issue **tomorrow**.

the day after

Papers & podcasts

In the new series of papers entitled "the day after", we share with our clients our thinking about what the long-term implications of the current, unprecedented crisis could be for the investment landscape.

THE DAY AFTER #12: CHANGING SHARES OF LABOUR AND CAPITAL INCOMES: WHAT IMPLICATIONS FOR INVESTORS?

The share of national income that is distributed to labour vs. capital has fallen to historically low levels in several advanced economies, such as the United States and the United Kingdom.

We believe the Covid-19 crisis, along with other factors, will trigger a rebalancing in favour of labour over the next two decades. A reversion to the long-term average ratio of labour and capital in the share of income would probably enhance social and political stability, and would better fit with a consumer-driven growth model. This would be positive for investors if it happens smoothly over a long period. However, such a rebalancing of the equilibrium will be inflationary in nature, with negative implications for assets with stable income streams. Both parameters should be included in the long-term asset returns assumptions used in our strategic asset allocation.

Read the paper online   Listen to the podcast online

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Amin RAJAN
Chief Executive Officer of CREATE

Asset allocation in the age of uncertainty

The extraordinary policy responses from central banks and their governments were timely and vital. But they also inflicted toxic side effects regarding pension finances via falling asset values due to plunging markets and ballooning liabilities from falling interest rates. The latter have also hit cash flows essential for regular pay-outs.

Plan sponsors are being asked to make big cash injections to bridge yawning funding gaps at a time when their own finances are taking big hits. As a result, they are seeking to downsize pension benefits and improve portfolio returns. Asset allocation is now under the spotlight.

For pension investors, assessing the macro-economic impact of Covid-19 has been akin to looking through a kaleidoscope: different images have appeared with every turn of the dial. Each narrative has seemed plausible as the pandemic has unfolded.

Scenario planning is now factoring in two potential outcomes:
- moral hazard, as governments have been forced to take massive risks with their extraordinary actions without much regard to medium-term unintended consequences; and
- rising prices, related to an unholy cocktail of excess spending, impaired productive capacity, interventionist policies that lift worker incomes, and deglobalisation that lifts industrial costs.

Portfolio resilience has raced up the pension agenda

With the global economy dogged by so much uncertainty, pension investors find themselves on a journey into the unknown. Relying on central banks to do all the heavy lifting to generate decent returns will no longer suffice. At the same time, it is not easy to adopt new investment approaches that have not been tested by time and events.

They are left with three options. One is to ignore the likely shifts: governmental intervention, nationalism, over-regulation, redistribution of wealth, inflation and fair value of asset prices. This in the belief that it is hard to know in advance whether they will actually materialise. In addition, markets have in-built automatic checks, balances and stabilisers. The second option is to adopt a pragmatic approach based on adaptive learning, as actual outcomes unfold over time. The third option is to adopt strong views about the likely future and make big calls in the hope that they work. These options are duly reflected in the Amundi-Create 2020 survey results. When asked about whether the pandemic crisis will mark a turning point in how they invest, 33% said 'very unlikely', 37% replied 'maybe' and 30% said 'very likely' (Figure 1.1).

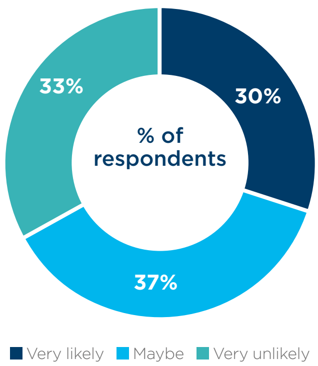
The last two groups had one common objective: to build resilient portfolios by way of strategies with strong intrinsic worth that can withstand high volatility and deliver good risk-adjusted returns, while pursuing accelerating structural themes that will reshape the key growth metrics in the post-pandemic world (Figure 1.2 - Strategies).

Resilience means investing on the side of change. It could be custom built, as is possible in private markets. Or, it could be pursued via specific themes like ESG, healthcare and technology. Or, it could be a strategy's inherent feature, as with cash flow compounders that act as shock absorbers in turbulent markets. Or, finally, it could have policy backstops, like the debt now being bought by the Fed.

In addition to risk factor diversification, portfolio robustness is now targeted by much stronger reliance on two tools to prevent a permanent loss of capital: scenario planning and liquidity management (Figure 1.2, Risk tools). The Covid-19 crisis has clearly shown how negative fat-tailed events can play havoc with portfolios.

Using the old probabilistic approach based on past pricing behaviour is no longer seen as sufficient. Back-to-basics characterises the new forward-looking approach.

Figure 1.1: How likely is that the Covid-19 crisis will mark a turning point in how investing is done?



"There is no free lunch in diversification. You need clear beliefs rather than blind faith in ex ante numbers. Past trends are not destiny."

Source: Amundi Asset Management / CREATE-Research Survey 2020

Figure 1.2: How likely is that the Covid-19 crisis will mark a turning point in how investing is done?

"The seeds of radical positive change are often sown in the depths of crises. The search for resilience can take investing back to its basics."

Source: Amundi Asset Management / CREATE-Research Survey 2020

Investing is now reduced to a single imperative: antifragility

A razor-sharp focus on resilience has been the immediate reaction, as known risks are overpowered by unknowable uncertainties. This is evident in a tug-of-war between the simultaneous existence of opposing forces: on the bull side, rocketing equity markets due to central bank support; on the bear side, deteriorating fundamentals in the real economy, as the pandemic has entered a second wave with its unique exhaustive power. In the dark, all swans are black. Hence, asset allocation will have two additional pillars.

One is liquidity. This allows bargain hunting during periodic market dislocations, while avoiding a liquidity trap if the outlook deteriorates. As with asset diversification, liquidity seems to vanish when it is needed most. Unlike other risks, it cannot be diversified away.

The other pillar is resilience. This ensures that investing is on the side of change. It means selectively targeting assets with policy backstops or inbuilt shock absorbers, or both. The aim is to select firms that can weather the storm and emerge stronger on the other side. Hence, asset prices are likely to reconnect with their fair values, as central banks' roles in artificially inflating asset prices and controlling volatility cross the point of diminishing returns.

> *“Businesses have ever more depended on policy makers for easy credit and generous bailouts to the detriment of entrepreneurial risk and more efficient allocation of capital.”*
>
> Amundi-CREATE survey insight

Investing will focus on firms that can weather the storm

As recessionary clouds gather with the arrival of the second wave of Covid-19, uppermost in the minds of pension plans is what to do if the ‘whatever it takes’ policy stance of key governments fails to stave off a deep recession. Within this broad context, the core beliefs that will underpin investing over the next three to five years is shown in Figure 2.

Three clusters are evident. Together, they mark a strong shift to the basics of investing but with a pronounced tilt towards resilience.

Figure 2: In light of the Covid-19 crisis, which of these statements describes your pension plan's investment beliefs over the next 3-5 years?

"The days of outsized share buy-backs and dividends, which artificially inflated share prices, are over for the foreseeable future."

"This crisis will not last for decades, but some of its effects will. Being nimble and forward thinking will be vital for survival."

Source: Amundi Asset Management / CREATE-Research Survey 2020

The first cluster reaffirms the old truism that in an era of heightened uncertainty and volatility, investing has to be long haul, as highlighted by 76% of our respondents. This is underpinned by three other beliefs:

1. Buy-and-hold investing will deliver better returns (52%), since asset values will tend to revert to the mean more regularly as markets become overly distorted by unusual policy action (51%).
2. Such reversions will re-connect valuations to their fair value (49%).
3. Thus, value investing may well revive after being dormant for two decades (42%).

The second cluster focuses on ESG, which is expected to become a structural feature of long-term investing that targets a double bottom line: doing good and doing well (63%). ESG will cut across a number of newly emerging themes that target the selective bright spots in the global economy, as it shifts from shareholder capitalism to a more inclusive stakeholder model.

Covid-19 has shown all too vividly that resilient economies need resilient societies. ESG investing is expected to be at the vanguard of the renewed drive towards resiliency.

The third and final cluster cautions against the limitations of old-style diversification based on asset classes. It no longer delivers a free lunch (36%). Indeed, it failed miserably when needed most amid the market rout in March 2020 as well as in the 2008 Lehman crisis.

Correlations between supposedly uncorrelated asset classes have proved asymmetric: low in the rising market and high in the falling market. This time, varying natures of correlations require greater granularity in the way assets are allocated. A certain degree of opportunism is required in periods of extreme market dislocations. Only 11% believe that a ‘buy the dips’ mentality will not be rewarding.

Thus, the Covid-19 crisis has reduced investing to a single imperative: antifragility. That means creating portfolios that can withstand pronounced periodic shocks in the near term, while targeting growth and income upsides thereafter.

The survey respondents now expect a low-return environment with pronounced volatility, since recoveries in national economies will follow varying time paths due to the uneven lifting of lockdowns globally. In the near term, only temporary relief is expected, not a full and stable recovery.

Asset allocation will pursue multiple goals

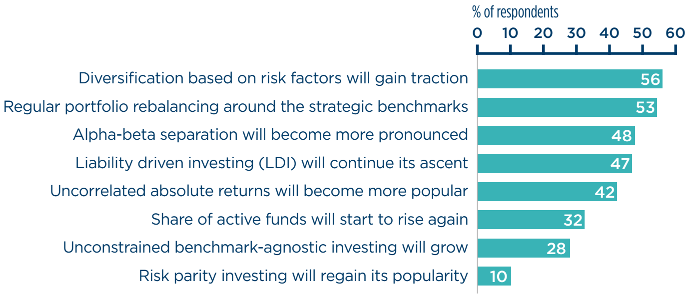
Hence, asset allocation will be recast in two respects: goals and selectivity. To start with, pension plans are targeting the following: capital growth to clear deficits; income to generate cash flows for regular pay-outs; capital protection to remain solvent; and hedges to manage unrewarded risks like interest rate, inflation and longevity. Apart from correlating with liabilities, hedges also target credit spreads, duration and liquidity.

47% of our respondents will be adopting these multiple objectives within their existing LDI programmes, as shown in Figure 3. Many others also expect to have a distinct slant towards them, given that high returns are unlikely in the challenging environment ahead. In all cases, however, the emphasis on cash-flow assets is dictated by the fact that DB plans are now advancing into their run-off phase with ageing demographics, pushing 64% of European plans into negative cash flow status in 2019. The trend will accelerate as many DB plans continue to close future accruals, with a rise of net cash outflows as a side effect.

In turn, these multiple objectives are likely to be pursued through marked selectivity in asset choices. First, 56% of respondents expect to diversify their risk by allocating assets by risk factors, instead of asset classes. Based on the belief that periodic dislocation will increase the correlation between historically lowly correlated asset classes. In the process, they will focus on macro factors – like GDP growth, inflation, volatility and interest rates – as well as micro factors – such as size, value, quality, variance, currency, capital structure and default rates.

The aim is to do a granular analysis of the behaviours of all asset classes under different future macro-economic scenarios before choosing the right ones. In the risk models, the emphasis will shift from the past to the future.

Figure 3: Which of these statements describe your pension plan's views on various asset allocation tools over the next 3-5 years?



"Markets have not been paying attention to the worst stealth tax – inflation. They should."

"In March, the correlation between equities bonds and gold rose, nullifying the benefits of diversification."

Source: Amundi Asset Management / CREATE-Research Survey 2020

Such selectivity will be reinforced via regular portfolio rebalancing as and when fresh market entry points emerge after periodic dislocations that open up big discounts to intrinsic value (53%).

Selectivity will accelerate the long-standing separation between alpha and beta (48%). Alpha strategies will focus on inefficient illiquid markets whereas beta ones will be used in deep liquid markets, especially in the West.

The search for uncorrelated returns will intensify so as to minimise the mark-to-market risk in periods of severe market dislocation (42%). It will serve to create tailwinds behind active management, since portfolio rebalancing is likely to occur more often than not (53%).

Finally, the twin emphases on a multiplicity of objectives and selectivity of asset choices is underpinned by one over-riding consideration: liquidity. The trade-off between liquidity and return is as valid as that between risk and return. Indeed, liquidity episodes in the last decade offer two lessons.

- First, liquidity injections by central banks, via low interest rates and bond purchases, invariably forced investors up the risk curve, creating countless convictionless trades under the illusion that liquidity will always be there while the global economy was awash with cash. Yet, the experience of the last three bear markets shows otherwise. Panic buying and selling have been all too apparent.
- Second, such episodes have been exacerbated in fixed income markets, due to the withdrawal of investment banks from their market-making roles under new regulations after the 2008 crisis. Banks now bear fewer risks by simply shifting them elsewhere in the system, notably on to investors. This shift is likened to pressing on a waterbed in one place which only causes the displaced water to move elsewhere in the mattress. Investors are wising up to this.

Resilience will be turbocharging theme investing

In previous crises, policy stimulus supported brick and mortar projects. In the current one, it is centred on green and digital sectors in the key economies. The European Union's Green New Deal worth €250-billion is a case in point.

Sectors that have been singled out include: life sciences, electric vehicles, renewable energy, green real estate, waste management, biotechnologies, advanced materials, smart cities, robotics, and the 5G and Wi Fi 6 digital networks powered by big data. Most of these are interrelated. Advances in artificial intelligence are fostering new industries from gene therapy to space travel. Crisis is accelerating change.

Megatrends have been powering these and other sectors this century. They matter to investors because they disrupt industries. They also give rise to clear and predictable sources of value creation. They have a multi-year return profile and favour intangible assets that make them relatively immune to the normal business cycles, as revealed by FAANG stocks, with digital-consumption going through the roof recently.

There is another reason why theme investing is set for take-off: the Fed's decision to keep rates 'even lower for longer'. This does not only amount to an arbitrary redistribution of wealth from savers to borrowers; it will also accentuate distortions in asset values as well as widen income inequalities.

The list of zombie companies, kept afloat by low rates despite overborrowing, will continue to grow. There will be a continuing shift in the capital structures of companies away from equity to debt, while overvalued bonds will take longer to return to their intrinsic values. Green bonds apart, they are no longer perceived as a safe haven. Above all, central banks actions risk a serious overreach that could roil markets from time to time. It seems unwise to rely on this to do all the heavy lifting when targeting good returns.

Against this backdrop, our survey respondents have identified strategies that are likely to influence their investment approaches (Figure 4). Their central thrust is directed at investing in structurally advantaged companies, sectors, regions and markets that enhance portfolio resilience, while targeting capital growth and income.

Taking these factors in turn, for capital growth, three interrelated strategies are likely to be targeted.

75% of our respondents singled out private markets. Apart from their traditional illiquidity premium, they are likely to shelter growth companies in growth industries running with the grain of the growth theme. Public companies are deemed too short-termist with their over-emphasis on quarterly numbers. In comparison, private markets are perceived to be more long term in their approach to value creation. For large investors, they also offer the opportunity to wield more influence via secure covenants that promise custom-made resilience in pursuit of various themes.

Another growth strategy centres on themes themselves (58%). ESG and digital will be among the most prominent, especially the former. Societies are expected to inch towards a more inclusive model of capitalism, as investors and consumers become more vocal about businesses perceived as failing to take their societal role seriously. In hindsight, Covid-19 is likely to be a watershed moment for ESG investing.

The final growth strategy relates to emerging markets (43%) on account of the favourable growth dynamics of the key Asian markets after successfully tackling the first wave of the virus.

Turning to income, two strategies are likely to be targeted. One is cash flow compounders, which relates to companies with strong balance sheets, free cash flow, strong brands and good pricing power (53%). Another is alternative assets like infrastructure and real estate that deliver regular cash flow and inflation protection (39%).

Overall, two imperatives underscore this pronounced emphasis on resilience: the structural trends accelerated by the pandemic and the selectivity they require in asset choices.

> *"Resilience is now the fourth pillar of asset allocation, alongside risk, return and liquidity."*
>
> Amundi-CREATE survey insight

Figure 4: Which of these statements describe your pension plan's views on various investment strategies over the next 3-5 years?

"The direction of our asset choices is influenced more by megatrends than business sectors."

"Our ownership mentality works best in private markets with a muti-year return profile."

Source: Amundi Asset Management / CREATE-Research Survey 2020

Index investing will tilt towards themes as it grows

48% of our survey respondents see alpha–beta separation as structural and likely to get more pronounced in the low-return environment of this decade, where fees will be a key source of outperformance when compounded over time. But there are other reasons as well.

To start with, alpha–beta separation marks the next stage in the evolution of the core–satellite model. It distinguishes between liquid efficient markets and illiquid inefficient markets. Markets have become more efficient as the number of talented asset managers has grown faster than return opportunities. Thus, whatever its size, alpha has to be shared between too many players - and investors have grown weary of paying alpha fees for beta performance.

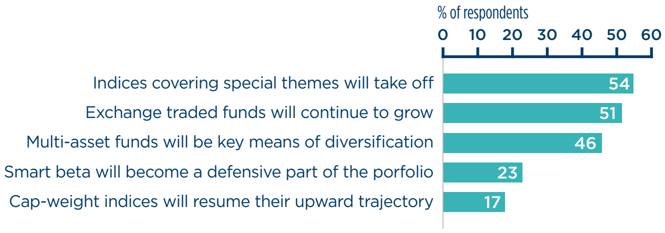
Another key reason is the liquidity pumped in by central banks whenever markets hit a turbulent phase. The QE programmes of the last decade marked yet another milestone in a long process that has, over time, turned returns into a monetary phenomenon, influenced more by central bank largesse than by the earnings boost in the real economy. By effectively providing a floor under asset prices and suppressing volatility, central bank action has distorted asset prices, undermining active investing in favour of plain vanilla passive funds.

As described earlier, the market rebound is more likely to favour theme funds, according to 54% of our respondents (Figure 5). The reason for this is simple: investment styles are only as durable as the forces that promote them. Passives are not an all-weather strategy. The focus on themes is meant to reduce big drawdowns in periods of market dislocation, while targeting durable hotspots in the global economy.

This is corroborated by the most narrow and unbalanced rally on record, which started after the market rout in March. The market cap-weighted version of the S&P 500 has massively outperformed the equal-weighted version: implying that the average stock did far worse than the overall index. Evidently, the gains were exclusively notched up by a few big tech giants in the US as well as in Asia. That trend has eased somewhat lately.

But the fact remains that: passives are viewed as a cost-effective vehicle for pursuing the newly emerging structural themes in this decade, as described in the previous subsection.

Figure 5: Which of these statements describe your pension plan's views about investment vehicules over the next 3-5 years?



"Passives and actives complement one another in the emerging core-satellite model. We index the core and manage the hell out of the periphery."

"The perception that the Fed would always intervene whenever markets dive has now become deeply ingrained in investor psyches."

Source: Amundi Asset Management / CREATE-Research Survey 2020

This observation especially applies to small and medium-sized pension plans with limited expertise and governance budgets. Hitherto, most of them have relied on passive funds for their global diversification.

Thus, traditional cap-weighted funds are likely to have slower growth, as cited by 17% of respondents. Their popularity rose over the past two years, when markets were experiencing strong upward momentum, especially since 2019, when the Fed reversed its rate hiking programme after the major market rout at the end of 2018.

In contrast, ETFs are likely to be favoured by 51%, since they are viewed as the perfect vehicle for executing risk-on/risk-off trades as and when the existing volatility regime changes. They are also favoured as a cash equitisation tool for parking excess cash that would otherwise languish in a near-zero-interest-rate bank account. Above all, ETFs will be at the vanguard of the march towards theme investing.

Finally, multi-asset funds will be favoured, especially by small- and medium-sized pension plans (46%). Such funds are perceived as having three positives.

First, their fees are charged on the net performance of all the strategies covered by each vehicle; unlike single strategy funds where fees are charged separately for each strategy, thus creating so-called 'netting risk'.

Second, multi-asset investing promotes a deeper understanding of changing correlations between various asset classes. This enables portfolio managers to identify problematic exposures and take timely pre-emptive action.

Finally, multi-asset investing offers managers greater latitude to hold more concentrated positions in their 'best ideas' portfolios that can potentially deliver the most attractive risk-adjusted returns via long–short strategies.

On the flip side, one charge frequently levied against multi-asset investing is that the sheer breadth of its universe often results in excessive beta exposure that can be readily replicated by long or short positions in ETFs.

To sum up, previous rounds of quantitative easing have brought forward future returns in an environment of anaemic global growth. In the prospective low-return environment, asset allocation will selectively target four goals, supported by the following asset classes:

- capital growth: global equities, EM equities, high-quality equities
- income generation: infrastructure, IG bonds and alternative credit
- inflation protection: equities and infrastructure
- capital conservation: sovereign bonds.

These goals will reinforce the alpha–beta separation, as fees become a key source of returns. They will also ensure that equities retain their gravitational pull. Passive funds will continue their advance into core portfolios while tilting towards secular themes.

Amundi-CREATE 2020 survey: highlights

(% of pension plan respondents)

Anticipating the likely fall-out-from Covid-19

84%
Key central banks are likely to lose their independance from their governements

84%
Inflation is likely to follow deflation once the current crisis is over

85%
Financial markets will experience either a W-shaped or an accordion-shaped recovery

90%
Asset returns will be lower in this decade compared with the last one

Accepting that central banks may lose their potency

81%
Central banks are likely to lose their potency in artificially affecting asset prices and their volatility

77%
Asset prices are likely to reconnect with their fundamental value

67%
Covid-19 is likely to mark a turning point in how investing is done as resilience tops the investor agenda

57%
Liquidity management will become the third pillar of asset allocation after risk and return

Building resilient portfolios

76%
Private markets will be targeted to achieve custom-built resilience via investment covenants

58%
Thematic investing will be targeted to achieve inherent resilience via secular global growth points

76%
high-quality cash flow compounders among global equities will top the asset allocation choice

61%
foward-looking scenario planning will buttress the conventional risk models

Making finance a force for good

80%
ESG funds have gone mainstream, accounting for more than 20% of their total portfolio

61%
Target good risk-adjusted returns from their ESG portfolios

52%
ESG funds performed better than the rest of the portfolio during the market crash in March 2020

82%
Expect to increase the ESG share in their total porfolio, so as to cater for fat-tail/far-off-risks

About the survey

Each year, Amundi and CREATE interview pension plans to highlight insightful convictions for the year to come. The 2020 edition aims to shed light on how pension plans are responding as the world economy struggles to recover from what is the economic equivalent of a massive cardiac arrest.

Taking a three to five year forward view, the survey aims to obtain their views on three core issues:

- what shifts are likely in the current macro financial regime in response to the unorthodox policy response?
- how will these shifts affect the way investing is done in future?
- what will be the key changes in pension plans' asset allocation?

The survey is based on 158 respondents from 17 pension markets, collectively managing €1.96-trillion of assets.

Read the full Amundi-CREATE report

Sofia SANTARSIERO
Business Solutions and Innovation Analyst

Isabelle ERIMO
Senior Thematic Marketing Manager

ESG resilience and innovation in a post-Covid-19 world

> *"Resilient economies necessarily need resilient societies."*

ESG resilience during the crisis

As highlighted in the results of the CREATE survey, one of the new pillars that will comprise the asset allocation exercise is resilience. Pension funds need to select investment strategies capable of both navigating well in the perilous waters of unexpected market downturns and of providing sufficient returns beyond the pandemic crisis. They have identified in ESG one of the possible strategies to enhance the resilience of their portfolios: most of the interviewed pension funds are in fact allocating at least 20% of their portfolios to ESG funds and they plan to increase this share even further.

ESG had been considered an increasingly important investment theme for institutional investors in the past decade; this trend is expected to greatly accelerate in the years ahead. It has already been proven by different studies from Amundi Research and other institutions that companies with better ESG policies and practices – in a word, ESG performance – were faring better in terms of growth in the share price than industry peers.

This result was also strongly confirmed in the peak of the downturn in Q1 2020. One of the most striking market-related results back in March was the greater resilience of ESG funds' performance compared to the benchmark: in fact, while the MSCI World fell 14.5%, 62% of large-cap equity ESG funds had a better performance than the index[1]. The majority of pension funds interviewed for the CREATE survey also confirmed this outcome: they found their ESG funds to have performed better than the rest of their portfolio in that time span.

ESG funds were more resilient not only in terms of performance but also of flows: in the US market, cumulative flows for ESG ETFs have jumped from January onwards in a fairly linear and positive manner, differently from the bumps and massive sell-outs experienced by traditional equity ETFs. In figures, the average daily growth of shares outstanding for ESG US ETFs was more than 4x higher than for "traditional" ETFs[2]. One of the explanations for this behaviour is the natural construction process of ESG funds which tends to overweight sectors that got through the crisis better, such as tech, and underweight sectors that were most affected, such as energy. Also, the generally longer-term investment horizons of ESG investors have likely had an impact on the resilience of flows.

Certain ESG themes were greatly strengthened by the pandemic. One of these is definitely the social pillar, previously far less popular than its environmental counterpart. One of the key lesson from the crisis was indeed that the success of ESG depends on a "just transition" to a low carbon future, ensuring that workers and local communities are included at every stage of the process. Simply put, the crisis has revealed that resilient economies necessarily need resilient societies.

Pension plans have been approaching ESG in different ways. Those more ahead in their "ESG journey" have already been allocating to solutions with higher potential impacts such as green bonds or pure impact investing, while others are preferring exclusions-based or best-in-class strategies.

The former should start considering investing in social bonds, a nascent segment of the sustainable fixed income market whose issuance grew substantially over the year pushed by pandemic-related financing needs. The latter should instead pay particular attention to Amundi's newest range of ESG Improvers solutions, characterised by a forward-looking, dynamic approach to ESG.

Amundi, with its far-reaching offering, can propose solutions to pension funds that fit within their ESG strategy and support them with its broad ESG experience and long track record of innovating for sustainable finance.

ESG Improvers

Our efforts to develop new ESG solutions have found even more resonance since the beginning of the year. Indeed, given the current Covid-19 crisis and the resulting market turmoil and volatility, the ongoing trends within equity investment have been confirmed: the increasing relevance of integrating ESG criteria and sustainability in investment decisions, as well as companies with better sustainability performance benefiting from lower downside risk and appearing as more resilient during turbulent times. Indeed, as previously illustrated, ESG equity funds have proved resilient throughout the crisis in terms of both flows and performance, with investors perceiving them as offering defensive characteristics.

Within this context and as investors increasingly integrate ESG criteria into their Strategic Asset Allocation (SAA), Amundi has recently launched a new ESG conviction-based strategy, *ESG Improvers*, which will be progressively deployed across a wide range of asset classes. This approach will consist of detecting and investing in companies with ESG momentum - i.e.- corporates benefiting from a solid fundamental investment case and an improving ESG profile. By being positioned "ahead of the curve" on these corporates, the investment team will capture the re-rating linked to the ESG premium not yet fully priced in by the market. In the current market environment, as there are still huge dispersions of ESG scores across both countries and sectors, the ESG Improvers strategy enables active managers to target companies that will benefit most from ESG profile improvements.

A way to capture this ESG premium available in the market consists of moving from a static best-in-class approach to a dynamic and forward-looking one, seeking tomorrow's ESG winners. Indeed, for investors who want to fully embrace ESG, it will be key to invest in a portfolio that is constantly improving its ESG footprint.

To identify ESG improvers, the investment platforms have decided to put 'materiality' at the heart of their approach, helping to detect companies with ESG dynamics. This will consist first in the analysis and the identification of the materiality of ESG drivers. The analysis will aim at understanding ESG drivers' financial impacts and changes over the years, as well as at assessing how they will reshape in the future.

Via this new approach, investors will capture new sources of alpha by being positioned at the early stages of the ESG rating migration. In addition, by blending two types of ESG company profiles in a portfolio, i.e. the ESG winners (quality companies with attractive valuations and strong ESG ratings) with ESG improvers (corporates portraying a solid fundamental investment case and an improving ESG trend), this strategy helps to achieve the optimal risk-adjusted return. ESG winners act as a sound quality foundation, while the improvers offer an additional source of potential growth and return.

Also through active engagement initiatives, this strategy will support the goal of improving returns in a sustainable manner, an objective increasingly shared by most pension funds.

Social bonds

As mentioned earlier, another point of interest for investors that emerged with the pandemic is the importance of the social pillar of ESG.

In this unprecedented context, investors should be concerned about the impact that social risks can have on asset values. In fact, Moody's estimates[3] that US$8trn of the total debt it rates is subject to material social risks, corresponding to 4x the amount exposed to climate change risks.

Given its potential for systemic destabilisation, the social dimension has rightfully come to represent an increasingly important theme for investors. In this regard, social bonds constitute a first solution available to pension funds to integrate social risks, as well as to contribute to the recovery from the pandemic and to support long-term inclusive growth. Social bonds are commonly defined as 'use-of-proceeds' fixed income instruments aimed at mitigating a specific social issue or at generating a positive social outcome. Projects in line with the International Capital Markets Association's Social Bond - that govern social bonds issuance - include affordable housing and access to essential services such as healthcare.

The current period is especially propitious for institutional investors to adopt this strategy, as the social bond market has been experiencing strong growth in recent years. Of the $1280bn in cumulative sustainable fixed income issuance, social bonds currently account for around 14% of the total, amounting to $180bn[4]. This overall expansion trend was significantly accelerated as a result of the Covid-19 pandemic: the social bond market has grown by 374% in 2020 compared to 2019 levels, surpassing the expansion of both the green and sustainability bond markets[5].

Considering this difficult context, Amundi is more committed than ever to further deepening its strong track-record in supporting the development of sustainable fixed income markets. Amundi will soon launch a Social Bond strategy allowing investors to contribute to financing socially beneficial projects, while supporting the development of this promising market. At the current stage of the market, social bonds can be an optimal fit in the thematic pocket of investors' fixed income portfolios. At the same time, they serve as a solid platform for engagement with issuers on social themes and allow investors to report their consideration for global social issues and to measure social impacts their investments are producing.

Amundi expects the market shake-up caused by the pandemic to support such growth in the aftermath of the crisis and beyond. Pension funds should consider jumping on the 'social bonds wagon' at an early stage to support the development of this innovative instrument and reap the benefits of the expected market expansion away from Europe and agency and supranational issuers and towards more attractive profiles.

1. https://www.ft.com/content/46bb05a9-23b2-4958-888a-c3e614d75199
2. https://research-center.amundi.com/page/Article/2020/05/The-day-after-3-ESG-Resilience-During-the-Covid-Crisis-Is-Green-the-New-Gold
3. https://www.economist.com/finance-and-economics/2020/06/04/esg-investors-get-their-heads-around-social-risks
4. Amundi analysis on Bloomberg database on social 'use of proceeds' bonds of 12 November 2020.
5. Amundi analysis, Bloomberg database on social & sustainability 'use of proceeds' bonds as of 12 November 2020. Bloomberg database on green 'use of proceeds' bonds as of 6 November 2020.

Jean-Xavier BOURRE
Senior oCIO Advisor at Amundi

Curing pension CIO's headaches: solutions to outsource complexity

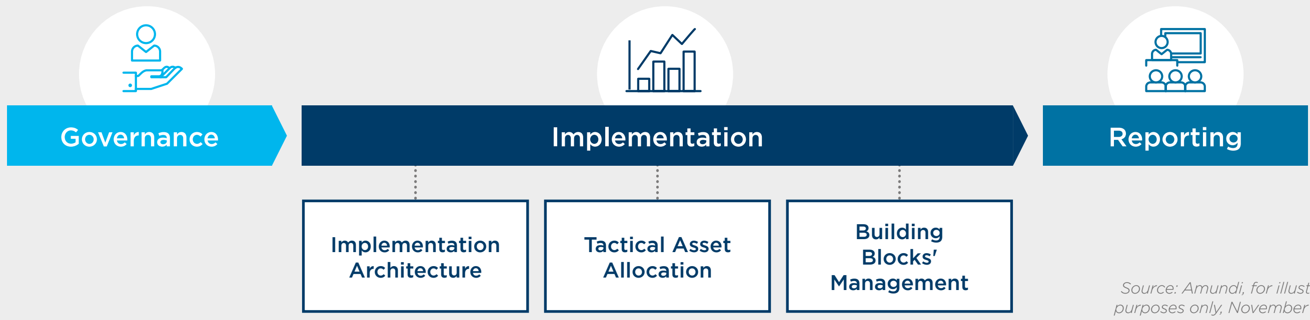
The 2020 CREATE Survey highlights that pension plans have been facing a series of operational and investment challenges in their fiduciary duty that the recent crisis has exacerbated. In order to perform efficiently their fiduciary duty, many pension funds have chosen to outsource all or part of complexity all along their value chain. And furthermore, because each pension fund has very specific needs, any outsourcing proposition requires to be extremely flexible and to offer a **high level of customisation**. An outsourced CIO (oCIO) may help the CIO to tackle all or some of these tasks successfully, by sharing not only the experience but bringing the necessary resources to accomplish the task in a predefined time framework and budget.

Negative real rates, capital markets, growing geopolitical and macro uncertainties, a greater interest for sustainability due to new interpretations of fiduciary duty are all calling for stricter asset & liability risk management. It also requires a **more dynamic asset management approach** to navigate the de-risking journey, as well as the ability to better harvest risk premia and build a more robust investment and implementation architecture to manoeuvre the whole business cycle.

In parallel, this increasingly intricate environment is pushing regulators to strengthen their frameworks, creating a patchwork of stringent, diverse and country specific governance, management, reporting and accounting rules. This requires pension funds to bear **increasing costs**, **reporting needs** and **technological complexity** in their systems and infrastructures.

One support to pension funds' CIOs may be to address its full value chain in a modular way, leaving up to the trustee the flexibility to choose what to outsource and more importantly, with the required degree of customisation they may need. It may result in a complete oCIO solution, or in a modular solution that will target support only on some specific elements of their value chain.

Illustration of the pension fund value chain in a modular approach:



Source: Amundi, for illustrative purposes only, November 2020

Here are some examples of actual issues experienced by pension fund clients:

GOVERNANCE

A CIO needs to incorporate ESG in its whole value chain, needs first to articulate its ESG beliefs and objectives, secondly, to incorporate them in the funds governance documents, guidelines and IMA. Then, he/she may also need to search for asset managers best equipped to effectively manage assets under these new guidelines. And last but not least, to develop specific reporting integrating different ESG metrics (ESG ratings, climate risk exposures, engagement).

IMPLEMENTATION ARCHITECTURE	**A CIO wants to use Amundi's platform to invest but to keep the responsibility of the allocation and ultimate investment decisions.** He/she may want to put in place Advisory services on manager/fund due diligence and selection. Once the funds selected, a CIO needs someone to actually place the orders, under his/her advice. The fund's cash flows management and its regular rebalancing are outsourced to keep track of the target asset allocation. Lastly, a risk monitoring is needed, that in this specific case, will translate in accessing our internal tool, ALTO* platform for this fund-of-fund portfolio.
TACTICAL ASSET ALLOCATION	**A CIO is looking to strengthen its asset & liability risk management framework.** Maybe because decision-making process requires some technological upgrades (risks were managed using Excel spreadsheets and systems being neither exhaustive, nor well integrated), it makes this pension fund's risk management and reporting extremely complex. A solution can be to look for a partner to outsource all its advanced risk management: - LDI completion by monitoring the distance between the asset allocation and liabilities, - Duration and FX hedging program implementation using derivatives and more efficient collateral management, - Tactical risk and drawdown management framework design and implementation to navigate market volatility.
BUILDING BLOCKS' MANAGEMENT	**A CIO is looking for better building blocks and harvest new risk premia to improve portfolio diversification.** Some clients are looking to access a comprehensive investment platform providing expertise in a wide range of asset classes with extensive performance track record. For specific conflict of interest motivations, the CIO may instead favour an open architecture to outsource the fund selection and monitoring, both for active or passive managers or even managers specialised in alternative assets.
REPORTING	**A CIO is looking to improve its reporting to trustees and regulators.** In addition to the production of regular reporting covering asset allocation, performance, risks and external managers, a CIO may be looking for specific dashboards. These will allow investment committees and trustees to have a comprehensive and synthetic view of both the current and forward-looking situations of the fund, including, but not only, funding ratio, hedging ratio, de-risking journey, market positioning, performance, risks or ESG scores.

As a conclusion, although they often face similar challenges, each pension fund has specific issues due to its own history, environment, jurisdiction and resources. In order to help them to deal with this ever-increasing complexity, partners may be assigned with different brands or names (oCIO, fiduciary manager, fiduciary oversight, whole fund solution, platform).

No matter the preferred name, partners should be able to offer an exhaustive range of services all along a pension fund's value chain, an open architecture mindset and advanced technologies. At the same time, it is crucial to offer high customization capabilities in order to build unique and tailor-made solutions around each pension fund's specific needs. At Amundi, our support to pension funds' CIOs addresses the whole value chain - in a **modular way**: partnering with pension funds from a complete oCIO solution to targeted support on specific elements.

The pension fund world has been experiencing crucial shifts over recent years: one of the most significant has been the gradual but accelerating shift from a Defined Benefit (DB) to a Defined Contribution (DC) design. Despite the undoubted advantages of DC, it is important to highlight that the shift is not a panacea for pension plans: it only partially solves the squaring of the circle of pension funds' Asset Liability Management (ALM) as it mainly transfers new risks from the sponsor to the members, while keeping under sponsor's responsibility the existing stock of liabilities. As such, even if the plans do not accrue new liabilities, trustees will need to put great effort into designing an adequate lifecycle grid for the new investment products, increasing transparency and developing tools to significantly enhance the personal engagement of members.

* ALTO: Amundi Leading Technology & Operations

Pascal BLANQUÉ
Group Chief Investment Officier

Vincent MORTIER
Deputy Group Chief Investment Officer

2021 Outlook: market rotations in an uneven recovery

The Covid-19 pandemic drove an unprecedented collapse in economic activity in H1, which was followed by a desynchronised rebound. The recovery phase has been uneven, with the virus cycle dictating the sequence of it. We believe that the damage to the global economy will last well beyond 2021. Output and personal income losses, the rise of inequality and the disruption in some sectors will be the legacies of the pandemic. Expecting that a vaccine will cause these to dissipate within a few months is too optimistic, in our view.

Expectations of additional fiscal and monetary measures will continue to mount in the coming months amid possible further waves of Covid-19. This will drive sentiment in financial markets, in line with the 'bad news for the economy, good news for the markets' narrative that saved the day for investors in this dramatic year of 2020. The performance of risk assets rebounded strongly amid the policy support. However, investors in a traditional balanced portfolio experienced a doubling of volatility compared with the previous decade, a nasty drying up of market liquidity and an increased correlation among risk assets. These features will affect portfolio construction in 2021 and beyond.

We see five investment themes to play in 2021 at a portfolio level.

From a cross-asset perspective, a rotation from credit (HY) into equities. Equities will likely have a better risk-return profile than high yield in a phase of mild recovery and earnings re-acceleration in 2021. **Investors should add exposure to cyclical stocks, quality value, and post-Covid-19 ESG themes.** Old-fashioned geographical diversification will come back into focus, thanks to global trade no longer driving global growth, the repatriation of value chains and the desynchronisation of cycles. At the same time, sector discrimination will become even more evident, providing additional diversification opportunities.

Move from fixed income to smart income. With the amount of negative yielding debt close to historical highs and interest rates expected to remain low in the short term, investors should build an income engine by searching for opportunities across the board, including emerging market bonds, private debt, loans, real assets (infrastructure, real estate), and high-income equities. Opportunities in credit markets remain, but the big theme for 2021 is what we call **'the great discrimination'**. What is sound and expensive will become even more expensive. Some areas of the market will likely deteriorate further, as the abundant liquidity injected by central banks is hiding weakening fundamentals. Selection will be key in 2021.

Consider govies for liquidity. Investors should consider allocating a portion of their portfolio to core government bonds, regardless of their valuations, primarily for liquidity reasons in case there are phases of liquidity shortages.

Play the recovery through emerging markets assets. In a still highly uncertain virus and economic cycle, the Chinese and Asian economies are emerging as the most resilient, having been able to effectively manage their outbreaks. So far, China has been the only country to recover to its pre-crisis GDP level. The outlook for EM countries in LatAm should also improve through 2021 as the virus cycle is improving in this area. These trends should support EM regional themes and EM bonds in local currency.

Include 'true' diversifiers. In a world of high correlation among risk assets, adding uncorrelated sources of returns may help balance the allocation. **Absolute returns approaches, volatility, hedging strategies and gold** may help improve overall portfolio diversification, as well as **real assets, private markets and insurance-linked securities.** Those asset classes show a lower correlation to traditional asset classes, and some, like real estate and infrastructure, can provide a hedge against inflation.

In the medium term, the **main risk for investors will be the de-anchoring of real rates and inflation expectations** due to the massive fiscal stimulus, the monetisation of public deficits, the rebalancing of social and political support in favour of labour, and the retreat of global trade. Markets are not pricing in this risk yet, but investors should start looking at strategies for a possible inflation comeback.

2021 Outlook

CROSS-ASSET: PLAYING THE (CHALLENGING) ROTATION FROM HIGH YIELD TO EQUITIES

The de-freezing of the global economy is our central case. Hence the growth theme remains key, although with different features vs. a 'normal' recovery. Investors should search for yield across the credit spectrum, favour inflation-linked bonds to govies, cyclical sectors and, selectively, EM assets.

How to navigate the fragile recovery environment

The second wave of the contagion is materialising and brings many risks to economic activities and uncertainties on many fronts. However a recovery remains our central scenario. **According to our macro-economic projections, the profits rebound should be robust, at about 30%, though this is lower compared to the consensus of 40%,** due to the fat tail risks (the probability of correction and contraction phases in our proprietary tool, the Advance Investment Phazer, is 20%). **Nevertheless, current profit expectations should be sufficient for a cross-asset risk rerating throughout 2021, focusing on growth-related asset classes such as equities, HY and GEM bonds.** The anaemic strength of the recovery would suggest, however, that investors should not play the highest beta markets too much but rather maintain a focus on quality and more defensive themes. For this reason, in DM we favour the equity space and in GEM we favour bonds. In a low-yield world, we prefer IG credit to govies for risk-adjusted carry reasons. Exposure to inflation linkers could help to mitigate any negative impact on the duration front, should rates move higher in case of inflation spikes in the upside scenario. On the commodity front, base metals are typically the best performers while at this time gold should also be considered as a way to hedge cross-asset allocations given the significant probability of the downside risk scenario and the ultra-dovish central banks.

How to play the growth theme in an unprecedented recovery

The severe recession induced by the pandemic led to an unprecedented situation in which HY spreads are artificially close to their historical lows. Historically, during recessions, DM HY spreads have been about 1,000 bps, so the current dislocation effect due to CB interventions is massive. For this reason, it's **unlikely during this crisis that HY will outperform equities in the central or upside risk scenarios.**

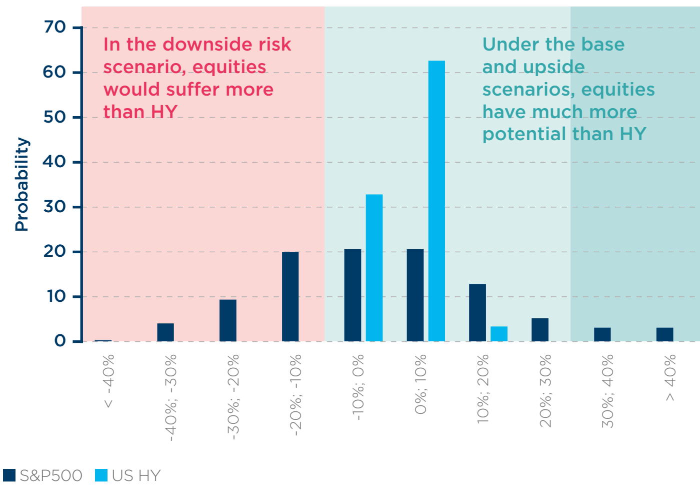
According to our fair value calculations, the expected returns distributions are significantly skewed to the downside due to the painful combination of fat tail risks, anaemic growth, and expensive valuations due to CB interventions. However, the upside is definitely capped for HY, due to limited spread tightening, while equities have much more space to overperform, should profits surprise to the upside.

Profits and fiscal stimulus implementation

One of the (few) risks to the upside is the full speed implementation of fiscal stimulus plans in the US (and Europe), which would boost our profits growth expectations by 10%-15%. In this scenario equities would be even more preferable.

On the downside, the corporate sector's vulnerability remains the key risk to monitor. In such an unpleasant scenario, equities would suffer more than HY, as CBs have proven to be more successful in controlling debt markets, and therefore de-risking would likely occur via equities selling.

According to our fair value calculations, equities have more upside than HY should the recovery surprise on the upside



The fair value calculation tool is an Amundi proprietary model that generates N- simulations according to our internal macro-financial forecasts and official probabilities of the economic financial regimes from the Advanced Investment Phazer. Based on the simulations' results, conditional expected distributions are calculated through Kernels estimation.

Source: Analysis by Amundi Research, Bloomberg, S&P website. Data as of 20 October 2020.

2021 Outlook

RISKS TO WATCH

RISKS & PROBABILITIES

	ANALYSIS	MARKET IMPACT
20% Financial instability due to multi-wave pandemic	Multiple waves of Covid-19 may trigger a sharp market correction and hit financial stability. Although the economic outlook remains uncertain, market participants remain confident that policy actions will be bold in the event of an economic relapse. The longer the crisis lasts, the greater the doubts will be on the marginal effectiveness of new measures and the capacity of authorities to implement them. Financial conditions would tighten. The magnitude of the recession would increase solvency risks regardless of CBs' actions and government guarantee schemes, and despite banks' stronger capital bases.	- Positive US Treasury/Bund and gold - Negative oil, basic materials, currencies of commodity-exporting countries, EM bonds
20% Increase in corporate defaults	Liquidity shortfalls, rising defaults and downgrades degenerate into bankruptcies and financial sector impairment. The magnitude of the recession increases solvency risks regardless of CBs' actions and government guarantee schemes. Banks' capital bases are stronger but corporate defaults and NPLs spike as state support fades and "grace" periods end (i.e., retail and commercial real estate). A financial crisis with widespread distress and deleveraging is a risk in countries that entered the crisis in a weak position.	- Negative for risky assets - US IG BBB downgrade, EURO and US HY B-CCC default increase - Positive for USD, DM sovereign bonds and gold
20% Hard Brexit	A no-deal Brexit in the context of partial lockdowns could push the UK into a deep recession, with spillover effects on the EU. With or without a deal, the UK will be outside the EU in 2021, and a phase of adjustment to the new framework will begin. As the UK will try to get trade deals outside the single market, with potentially better terms, it could create tensions between EU members with similar economic priorities.	- US equities underperform, raising risk asset volatility
10% Post US elections, frictions to redesign the political board	The outcome of the US elections is unlikely to change the US stance against China. 5G, foreign holdings, the situation in HK, potential US sanctions on Chinese banks and a Phase 2 of the trade deal are all topics that will make a strong comeback in 2021. This "cold war" might also extend to Europe. The EU received the green light from the WTO to hit the US with US$4bn in tariffs on the back of Airbus Boeing and France has initiated a tax on Big Techs.	- Risk on the HK peg - Negative for Chinese equities and CNY - Positive for USD, JPY, UST and gold - The harsher the escalation, the more detrimental it is for risky assets
10% Inflation surprise	QE programmes may become problematic during the recovery phase when inflation enters the equation. In EM, inflation is at an inflection point. DM governments' responses to rising inequality and social instability could change the inflation dynamics. The unknown reaction function of CBs confronted with a positive shock on inflation (or on inflation expectations) could be a source of uncertainty. This risk is very low in the coming year, but is expected to increase over time.	- Positive TIPS, gold - Positive equities, rotation from growth into selected value and sectors with pricing power that are investment driven - Negative long-term UST and Bunds
10% EM financial crisis	The health and economic crisis is potentially conducive to geopolitical stress and national instability within EM. At this point, there is no identified 'systemic' crisis with market impact, but a number of events must be monitored such as Libya, Greece/Turkey, Lebanon, Belarus, the protests in Eastern Russia and the India and China frontier dispute. For Turkey, which is already on very thin ice with domestic imbalances flashing warning lights, the economic headwinds carry additional risks.	- Negative EM equities and LC debt - Positive UST - Positive gold, USD and CHF

Source: Amundi Research, as of 10 November 2020.

2021 Outlook

AMUNDI CONVICTIONS FOR 2021

	Asset class	2021 view	2021 outlook rationale
EQUITIES	US	=	The US economy is due to return to 2019 levels around mid-2022, after China but before Europe. A steepening of the yield curve and a weaker USD should help the more cyclical/value markets to rebound first, but the US, which is rich in disruptive stocks, is a winner due to its low rates, which will be the other part of the equation in 2021.
EQUITIES	Europe	=/+	In 2020, the EU Recovery Fund made Europe investable again. In 2021, the strong relationship between EMU and MSCI World in bond yields should eventually help the region to benefit tactically from a steepening of the yield curve. The more defensive UK, also a proxy for energy (ESG unfriendly) vs. industrials (among the winners of the next cycle) will likely still lag.
EQUITIES	Japan	+	Japan is one of the most cyclical markets, with the biggest weighting in industrials (20%), a winner of the coming cycle, and consumer discretionary (18%) the second biggest. As such, Japan is a candidate to benefit from the recovery. The biggest headwind would be a strong rebound of the JPY, which we do not expect if global risks eventually fade next year.
EQUITIES	Emerging markets	+	EM are an interesting combination of secular technology-related sector plays (IT, consumer discretionary and communication services), mostly in North Asia, and more traditional cyclicals (financials and materials), especially in LatAm and EMEA. Asia has been strong in 2020. A USD breakdown would be a catalyst for a broader EM outperformance.
FIXED INCOME	US govies	=	As the recovery progresses, the medium-term trend will be for the curve to continue to gradually steepen on the very long part. The extent of the steepening will be contingent on the evolution of the virus and on the fiscal stimulus put in place after the elections. The inflation premium at the long end of the US curve should continue to rise moderately
FIXED INCOME	US IG corporate	=	We maintain a constructive view on US IG on the back of: (1) central bank support; and (2) the search for yield. The curve steepened with Fed buying and the sweet spot is in 7-10Y.
FIXED INCOME	US HY corporate	=	We expect to see increasing fragmentation in US HY on two fronts: (1) companies that maintain high cash levels for any contingency vs. those that burn cash to sustain themselves; (2) the increasing gap between sectors (tourism, energy) that experienced heavy falls in revenues vs. those that witnessed higher sales (technology). For investors, this means idiosyncratic and default risks are not correctly priced in and spread compression will not be uniform. As a result, attention to selection and quality is paramount.
FIXED INCOME	European govies	-/=	On the back of unattractive valuations and with an expected stable outlook for yields, we maintain a cautious view on core government bonds. However, on peripheral debt, we remain positive amid strong ECB support, to be strengthened further in 2021 through additional purchases and coming EU support, starting with the SURE programme.
FIXED INCOME	Euro IG corporate	=/+	Despite most of the spread tightening having been delivered, IG and especially BBB-rated corporates are still targeted by yield searchers and look resilient thanks to ongoing ECB QE. We continue to prefer EUR over US, due to the lower leverage in the latter, and play this through financial and subordinated debt that offers the potential for extra yield.
FIXED INCOME	Euro HY corporate	=	Among European HY we recommend the higher quality segment (BBs in particular), in order to combine the need to reduce volatility and to profit from remaining carry. EUR HY continues to be more resilient to default risk than US HY, thanks to its higher credit quality and sectoral exposure. However, the need for selection and cash buffers remains high.
FIXED INCOME	EM bonds HC	=/+	While the spread tightening potential in EM bonds is limited for 2021 given what has already occurred in 2020, we believe the asset class could still benefit from inflows from investors in search of carry in a world of low rates. Among EM asset classes, HC debt would be the most resilient in case of a deterioration of the outlook.
FIXED INCOME	EM bonds LC	+	In a scenario of economic recovery, the low yields in DM and the weak dollar are supportive for EM debt in local currencies and the FX component should benefit in 2021. However, selection will be relevant as some countries are still vulnerable in the current uncertain environment.
OTHER	Commodities		In 2021 commodities will be supported by the recovery in the economic cycle and by the still favourable financial conditions. WTI oil should stay in the $40-50 range in H1 2021, while base metals should also recover. Gold will also benefit from easing central banks and is favoured in the case of continuing uncertainty.
OTHER	Currencies		A shift from a contraction phase to a recovery will likely put the USD under pressure. A broad USD move lower is expected, but considering the higher policy flexibility and the direct link to China, we believe commodities-related currencies will be the relative winners in G10. On EM FX, volatility will remain throughout 2021, but some appreciation is on the cards.

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Negative view Neutral Positive view

Source: Amundi, as of 12 November 2020. 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.

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Research Center

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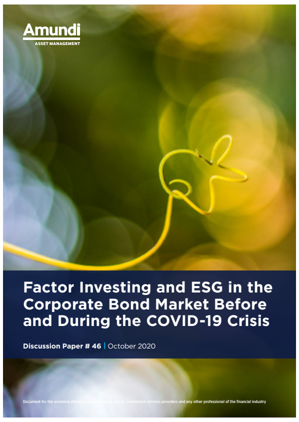

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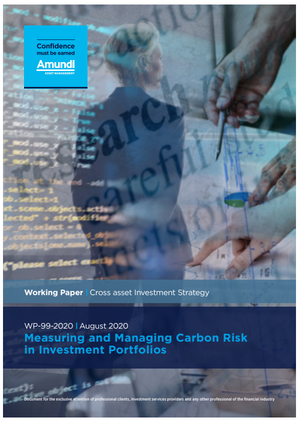

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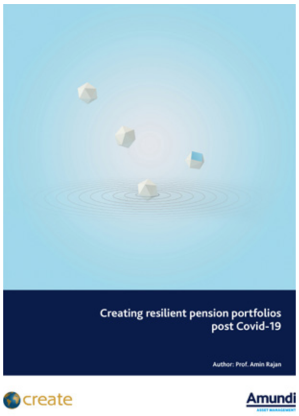

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