CENTRAL & ALTERNATIVE SCENARIOS (12 TO 18 MONTHS HORIZON)

Monthly update

We amend the narrative of our scenario to take into account the consequences of the war in Ukraine. We increase the probability of our downside scenario to 30% (from 15%) to reflect the rising risk of stagflation. The probability of our central scenario is moving down to 60% (from 70%) while the probability of the upside scenario is reduced to 10% (from 15%). We expect a repricing of risk premia across the asset classes in this new geopolitical and economic context.

DOWNSIDE SCENARIO 30%

Renewed slump toward stagflation

Analysis

- Long lasting **war in Ukraine** is hurting confidence and activity, and pushes commodities and energy price higher for longer, and disrupting supply.
- **Covid-19** Omicron resurgence leads to renewed mobility restrictions and bottlenecks.
- Both triggers lead to an **economic downturn** while **inflation** remains elevated and uncontrolled.
- **Renewed monetary and fiscal accommodation,** possibly a further step in financial repression.
- Inflation amid slower growth, forces some **Central Banks** and the ECB in particular, to **deviate** from their guidance and potentially lose credibility.
- Policies and investments designed to fight **climate change** are postponed and/or countries policies are disorderly implemented.

Market implications

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

CENTRAL SCENARIO 60%

Bumpy road, regional divergences

Analysis

- The **war in Ukraine** is hitting confidence and pushes commodities and energy price temporarily higher.
- **Covid-19** becomes an endemic disease, with random contagion waves.
- **Global activity** to hold better than previous waves, but supply chain bottlenecks will remain until end-2022.
- **Growth** progressively abate to trend in 2022. Opening 2023's to downside risk. Soft patch in H1 2022 due to China's slowdown, negative impact of Omicron and accelerating inflation.
- Persistent **inflation** pressures throughout 2022 due to high energy and commodity prices, supply-side bottlenecks, rising wage pressures; and abating in 2023. Inflation is a psychological and political issue.
- **Monetary policy asynchrony:** Fed in fast move from tapering to a light QT and initiating a hiking cycle; BoE in a soft hiking cycle, ECB recalibrate QE and potentially hiking rates; and PBoC on an easing bias. Rates to move higher but to stay low for longer.
- **Fiscal policy:** withdrawal of some support, but public funding and subsidies are used to smooth the impact of the energy transition on households in the short term.
- **Climate change** bites into growth and pushes commodity and energy prices higher, adding to stagflationary trends.

Market implications

- Lower risk-adjusted expected returns real
- Contained steepening of US Treasuries yield curve as well as EZ and EM
- Inflation hedge via gold, linkers and equities
- EM: Short-term caution, long-term real income and growth story intact

UPSIDE SCENARIO 10%

Inclusive and sustainable growth

Analysis

- The **war in Ukraine** ends quickly with limited disruption of the energy and commodities market.
- **Endemic recedes** more quickly than anticipated, despite variants.
- Extra savings and wage rises fuel **consumption** with low erosion of corporate margins.
- **Productivity gains** thanks to digital and energy transition and structural reforms.
- **Inflation** remains under control.
- **Higher interest rates,** due to stronger investment and less savings.
- **Central banks'** policy normalisation is well received by financial markets.
- **Debt is sustainable** thanks to strong growth and a gradual shift towards fiscal discipline.
- **Inclusive growth** and effective fight against inequality.
- **Possible triggers** include structural reforms, effective drugs and vaccine campaigns, and inclusive de-centralised finance.

Market implications

- US Treasuries curves bear steepen
- Favour risky assets with cyclical and value exposure
- Favour linkers as an inflation hedge

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

TOP RISKS

Monthly update

We increase the probability of economic and geopolitical risks to 30% from 20% to take into account the war in Ukraine and its potential implications on the economic and financial risks. We consider Covid-19-related risks to be part of the economic risks.

Risks are clustered to ease the detection of hedging strategies, but they are obviously linked.

ECONOMIC RISK 30%

- **Global recession** driven by an oil and gas shock and a deteriorating sentiment as the war in Ukraine stalls
- **Economic crisis in Eastern Europe** following a collapse of the Russian economy, elevated energy prices, uncontrolled inflation and a migrant crisis
- **Pandemic 3.0**
  - After Omicron (2.0) a more dangerous and vaccine resistant variant starts a new wave
  - New lockdowns or mobility restrictions could further undermine the global recovery
- **Supply chain disruptions** carry on, and input cost pressures lead to corporate earnings recession
- **China property market collapses,** leading to lower growth prospects
- **Monetary policy mistake**
  - Central banks' miscommunication in the context of a high geopolitical uncertainty.
  - Central banks underestimate the strength of supply driven inflation and lose control
- **Climate change-related natural events** hurt growth visibility and social balance

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

- **Risky assets, AUD CAD or NZD, EM local CCY**

FINANCIAL RISK 20%

- **Sovereign debt crisis**
  - The extended war would hurt DM vulnerable public finance with public debt as a share of GDP already at historically high levels
  - Most countries are vulnerable to rating downgrades and rising interest rates.
  - De-anchoring inflation expectations could lead to a bond market dislocation and harsher monetary tightening
  - EM weaknesses could also face a balance of-payments crisis and increased default risks
- **Corporate solvency risk increases**, despite improving fundamentals as uncertainty rises and corporate margins are under pressure (high input cost, double orders lead to profit warnings)
- **Widespread greenwashing and ESG investment bubble** undermine the energy transition funding
- **USD instability** and gradual loss of its reserve currency status lead to unstable currency markets

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

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

(GEO)POLITICAL RISK 30%

- **War in Ukraine***
  - Short term resolution following Russia military success: markets instability remain as investors are starting to price in Putin crossing new red lines
  - Prolonged military struggle leading to a high intensity conflict leading to western military confrontation and potential market capitulation
- **EU political fragmentation** and populist vote bring a disagreement on how to manage the relationship with Russia
- **The US takes a hard line with China** in order to block any tentative to invade Taiwan. Accidental confrontations in the South China Sea or the Taiwan Strait
- **EM political instability driven by:**
  - Chaotic virus crisis management
  - Higher food and energy prices, leading to a wave of unrest similar to the Arab Spring
- **US & China lose credibility** on the energy transition and undermine the Paris agreement
- **Global warming** leads to an increased risk of conflicts, driven by water shortages and migratory movements
- **Cyber-attack or data compromise,** disrupting IT systems in security, energy and health services

* *For more detailed on potential outcomes see Special Ukraine table P. 12*

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

- **Credit & equity, EMBI**

DISCLAIMER TO OUR FORECASTS

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

METHODOLOGY

— Scenarios

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

— Risks

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

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