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PENSION FUNDS LETTER

Confidence must be earned

Amundi ASSET MANAGEMENT

Building together smart solutions to face a challenging environment

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EXECUTIVE SUMMARY

The big reshuffle shaking up pensions

Every June, Amundi welcomes clients from around the world to its investment forum in Paris to discuss the new trends shaping investment. That the world has been approaching a critical juncture has been a stable topic of the past few years. But this year, the consensus was clear: We have embarked on a new era.

However, what is equally clear, is that the pandemic, the war in Ukraine, the return of inflation, the end of the globalization dream have left us on unsettled and often unfamiliar ground.

The aim of the Amundi World Investment Forum, and indeed much of the material we publish for our clients, is to provide clear, insightful and thought-provoking material that looks more closely at the factors at play and helps you decipher some of the many conflicting signals. While we may not be able to predict what will come next, we can do our best to be prepared for every eventuality.

Uncertain times mean investors must look beyond traditional allocations. In this edition, we start by turning our attentions east. Whilst the US teeters on the edge of recession and growth remains sluggish in Europe, **emerging markets are set to benefit from much stronger growth** in the months and years to come. China, India and other emerging economies are the growth engines of the future and investors, on the whole, remain underexposed. We look at how a cross-asset approach can be effective for investors like pension funds.

The pensions industry too has reached a pivotal moment. Demographic trends, low yields and now the return of inflation have led to the re-evaluation, not just of portfolios, but of pension structures as a whole, as the **shift from DB to DC accelerates**. The pension system in the Netherlands has long been held up as a gold standard for pension systems, so the pension reforms announced in May will be a crucial test for others to observe.

The last time the US and Europe saw such **high inflation levels** was the 1970s. The similarities between the two eras has been written about before in these pages. But how far do these similarities go and what should we expect next? Our third article shares some of our latest convictions on the current regime shift.

We end this letter with our regular analysis and latest changes in the pension funding ratios in Europe and the US.

Finally, if you weren't able to join us for this year's **Amundi World Investment Forum**, watch out for the link to the replays later in this edition, where you can **catch-up on what you missed**.

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How can pension funds access alpha opportunities in Emerging Markets?

Despite the turbulent market backdrop and elevated geopolitical risks, emerging markets continue to offer an attractive and diverse investment opportunity set for pension funds. However, **extracting value in emerging markets remains a challenge as the universe comprises a variety of idiosyncratic situations, each driven by distinct factors. A 360° perspective is needed to extract maximum value.**

Emerging markets; a heterogeneous asset class

The emerging markets universe has experienced a striking transformation against a backdrop of structural macroeconomic changes and a rapidly evolving geopolitical landscape. While there are some common forces driving returns, our view is that **emerging markets should not be considered a homogenous asset class**. Wide disparities exist across regions and countries, which become particularly evident when there are massive dislocations in markets.

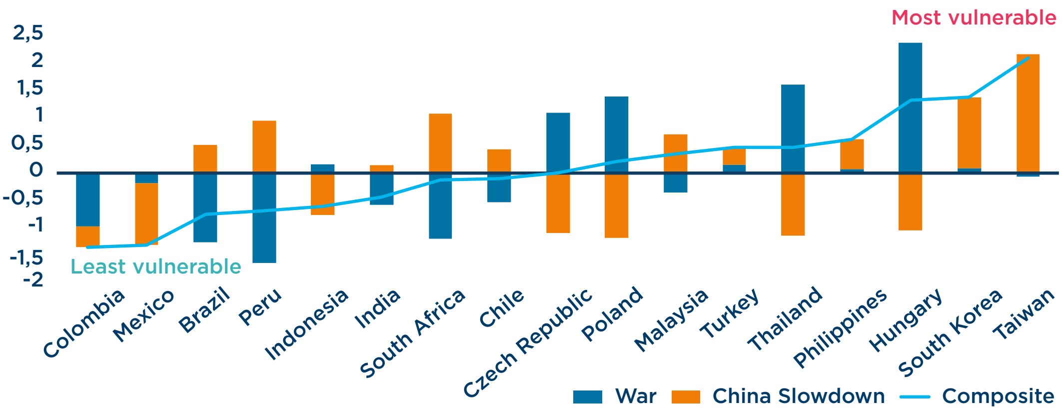
An active investment approach that considers such divergences can add significant value. **Determining the impact of macro factors driving the risk and return across emerging market countries**, based on an assessment of where they are in the market and/or economic cycle is essential.

For instance, commodity-exporters may be favoured during an uptrend in the commodity cycle. Similarly, countries with large external deficits will likely be more vulnerable to capital outflows in a slowing global growth environment.

The magnitude of external deficits, or more generally, the dependence of countries on foreign capital flows, is a key differentiating factor across emerging markets. Countries with strong balance of payments positions should outperform structurally vulnerable countries, in the context of a global economic slowdown – on FX, equity and debt markets – especially in times of crisis, contagion or risk aversion. However, throughout history, during phases of market stress, most emerging market countries have been impacted by capital outflows in an indiscriminate manner. Net creditor countries, however, are less vulnerable to external shocks as they have more buffers in place should they face capital outflows.

Analysis indicates that there is **a broad dispersion across emerging countries in terms of their vulnerability to external shocks**. Figure 1 illustrates the impact of two major shocks – the Russia-Ukraine war and the slow-down in China – on different emerging market countries.

Figure 1: EM Risks: Russia-Ukraine War & China Slowdown



Source: Amundi Institute on ComTrade, IMF, CEIC, Bloomberg. Data is as of 4 November 2022. For illustrative purposes only. The analysis of the impact of the Russia-Ukraine war considers two parameters, namely 1) exposure to commodities through net exports, inflation basket (energy and food prices) and reliance on fossil fuels. 2) trade exposure to Russia-Ukraine-EU while the analysis of impact of Chinese slowdown is measured by the country's exposure to China. The analysis takes into consideration the policy room available to the country to offset the external shock. Policy room is measured by monetary policy (external and domestic vulnerability with a focus on inflation) and fiscal policy. Finally, the composite is an aggregation of the impact on the two shocks and the policy room available to that country to withstand the shocks.

Brazil, for example, is somewhat vulnerable to China's growth slow-down as China is its biggest importer of iron ore. But it is relatively insulated from the war as it has a low trade exposure to EU countries (mainly Germany), Russia and Ukraine. Moreover, the country is one of the least vulnerable emerging markets due to its high adequacy of reserves and relatively low external debt burden, which allows for more monetary policy flexibility amidst rising inflation. Brazil's composite indicator based on this analysis shows it to be **one of the least vulnerable countries** to these dual shocks.

Structural reforms also drive heterogeneity in the performance of emerging markets as they may lead to varying growth profiles across emerging economies. **Countries who implement structural reforms have greater potential to generate sustainable growth and thus attract long-term foreign capital in the form of FDI (Foreign Direct Investment)**.

In China, the government's reform agenda has supported greater innovation and an allocation of capital towards more services-oriented, skilled industrial and green sectors. This has opened up unique investment opportunities for equity investors, who can capitalise on the de-coupling of China's growth cycle from the rest of the world. On the other hand, bond investors maintain a more cautious outlook given concerns around debt sustainability in some sectors.

Macro factors influencing the risk-return potential across emerging market countries and regions:

- External trade
- Energy dependence
- Dependence on commodities
- Debt levels
- Divergent central bank policy trajectories,
- External vulnerability (external debt, dependence on foreign capital flows, etc.)
- Political stability
- Government policy and state involvement in corporates

Political stability has historically been another source of concern for emerging markets, in some cases driving economic/financial crisis or, worse, social unrest or civil war. There have been numerous instances of this in Latin America. Evaluating variables such as **political trends, policy consistency and continuity, legislative initiatives as well as the electoral calendar and implications for macroeconomic policy is, therefore, crucial for assessing investor sentiment (and flows) towards emerging market countries**. The robustness of the country's institutional framework is also important in this context; the stronger a country's institutional framework, the lower the risk that changing regimes will have a significant impact on the systemic course of a country.

Macroeconomic factors such as differences in vulnerability to crisis, political cycles, structural reform implementation, etc. impact emerging market countries and regions disproportionately. **Investors should consider emerging markets as a heterogeneous asset class and embrace a more selective approach to capture country- and regional differences and mitigate risks.**

A cross-asset investment approach for more efficient portfolios

While selectivity in a world of heterogeneity is important, a **360° cross-asset investment approach results in efficient portfolio construction as it considers a more comprehensive set of factors that may impact risk and return**. A deep understanding of a company's capital structure is required to gain a broader perspective and to uncover the most attractive investment opportunities. For instance, an **equity portfolio manager** who is most concerned about a **company's long-term growth sustainability** and financial stability could benefit from a fixed income investor's understanding of a company's liabilities and debt structure; all of these factors may impact a company's long term growth outlook and therefore, return expectation.

Understanding these factors from both an equity and debt investor's perspective, including geopolitical risks, interest rates, macro and sector views are, in our view, key to deepening an understanding of the broader environment faced by companies in order to select the most attractive.

Common factors drive returns across emerging markets sub-asset classes, but their impact is varied

While the return potential from emerging markets sub-asset classes is largely influenced by macroeconomic factors, idiosyncratic factors are also important considerations. The varying return **impact from these drivers across the sub-asset class creates unique investment opportunities**.

According to analysis[1] of data from 2009 to 2019, US monetary policy, which is considered a significant driver of emerging markets external debt returns, has historically been a modest contributor to returns. This is, in part, due to the period examined, when growth and monetary policy cycles became highly correlated due to rapid globalisation. Therefore, what one might intuitively attribute to monetary policy is actually captured by global growth, which is a key driver of emerging markets external debt returns.

On the other hand, the historical returns **for emerging markets currency and equity markets have been largely attributable to global growth** as a return driver (over >50% of returns can be attributed to global growth), which as expected, is due to the effect of rapid globalisation over the period. Local currency government bonds prove most exposed to global growth and US Fed policy, while idiosyncratic factors such as company fundamentals or industry dynamics are important drivers for corporate debt as well as equities.

1. BofA Global Research utilising 10 years of data from 2009 to 2019. Emerging markets Viewpoint - Year Ahead 2023: Re-Emerging Markets, published on 22 November 2022.

View returns sustainability in the context of risks

The Amundi emerging market team's investment objective is to extract the potential return premia while managing overall risk exposures, including ESG risks, to mitigate any negative impact. **Sustainability of potential returns** therefore needs to be assessed **in the context of the risks** (Figure 2).

When analysing a company, an in-depth diligence of its business fundamentals, sector/industry trends and market drivers from both a fixed income and equity perspective is required. Equity investors are most concerned about long-term growth prospects and financial stability while fixed income investors are focused on debt sustainability (capital preservation and income generation potential). A combination of these factors and analysis is necessary in order to establish a truly comprehensive and holistic view of a company. Along with financial analysis, **relevant trends and themes such as environmental, social, governance, demographic, regulatory and technological issues need to be considered**. For instance, if the company can benefit from a demographic dividend, the ideal investment may be through equities. However, if the market turns, bonds are better positioned to withstand downside risks.

While credit and equity markets are symbiotic, they are not always efficient. Therefore, **a deep understanding of a company's entire capital structure provides a holistic perspective and helps to uncover the most attractive investment opportunities**. A detailed assessment of the company's sustainability - strength of the company's balance sheet and its financial health – is therefore critical.

A fixed income approach may associate low debt levels with better financial health of a company. On the other hand, a lower proportion of debt to equity may be considered inefficient if the company appears to be missing out on the potential for return on equity maximization.

It is essential to capture all angles (both debt and equity) of a company's fundamentals in a due diligence process. Capital intensity can vary extensively between industries. In the banking sector, financial leverage is high so banks can support lending activity. In telecommunications, capital expenditure and hence leverage may be high to facilitate infrastructure investment and maintenance plans.

Ultimately, an **in-depth understanding of a company's capital structure can help determine if positioning in the company's bonds and/or equities is warranted**.

Finally, it is also important to consider the extent of government support as the implication from an equity perspective is different from that of a fixed income perspective. Companies with strategic importance to the country may withstand economic pressures better than peers with no government support. For a quasi-sovereign company, proximity to the government renders it vulnerable from an equity returns' perspective when the company is used for public policy implementation, but remains well-protected during crisis periods, thus benefiting fixed income investors.

In conclusion, pension funds and other investors should approach analysis of emerging markets through multiple lenses to optimise instrument selection and positioning in portfolios.

Figure 2: Risk exposures by sub-asset class and associated investment considerations

	INVESTMENT CONSIDERATIONS (in benchmarked portfolios)	INVESTMENT CONSIDERATIONS
External Debt (Hard Currency)	– Contribution to Duration Times Spread (DTS) – Ex-ante tracking error	– Macroeconomic fundamentals – Political risk factors – ESG considerations – Technical factors
Local Debt (Local Currency)	– Nominal yield – Contribution to duration – Ex-ante tracking error	– Macroeconomic fundamentals (inflation, monetary, policy) – ESG considerations – Relative levels of real yields – Shape of the local yield curve
FX	– FX Risk EM – FX Risk G10 – Ex-ante tracking error	– Macroeconomic fundamentals – Central Bank policy action – Political risk factors – Technical factors
Corporates	– Contribution to Duration Times Spread (DTS) – Ex-ante tracking error	– Corporate and macroeconomic fundamentals – ESG considerations – Political risk factors – Technical factors
Equities	– Beta – Ex-ante tracking error	– Corporate and macroeconomic fundamentals – ESG considerations – Political risk factors – Technical factors

Source: Amundi Asset Management as of Dec 2022. Duration Times Spread (DTS) is a bond risk measure which incorporates the country's spread and its sensitivity to changes in spread. Beta is an equity risk measure which indicates the sensitivity of a stock to the market.

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A new model for pensions? Dutch pension reform accelerates transition to defined contribution

The Dutch pension system is considered by many as one of the most advanced in Europe. The Netherlands has recently been ranked second worldwide[2], in a study comparing the performance and sustainability of pension systems. As such, it is a leading indicator of what may happen in other European countries. On May 30 2023 the Dutch Senate adopted the '*Wet toekomst pensioenen*' (Future Pensions Act), a reform of the Dutch pension system to transition the current defined benefits (DB) plans to a defined contribution (DC) system, with some degree of collective investment and risk sharing.

The current Dutch DB structure

Benefits are "guaranteed" but inflation indexation is not

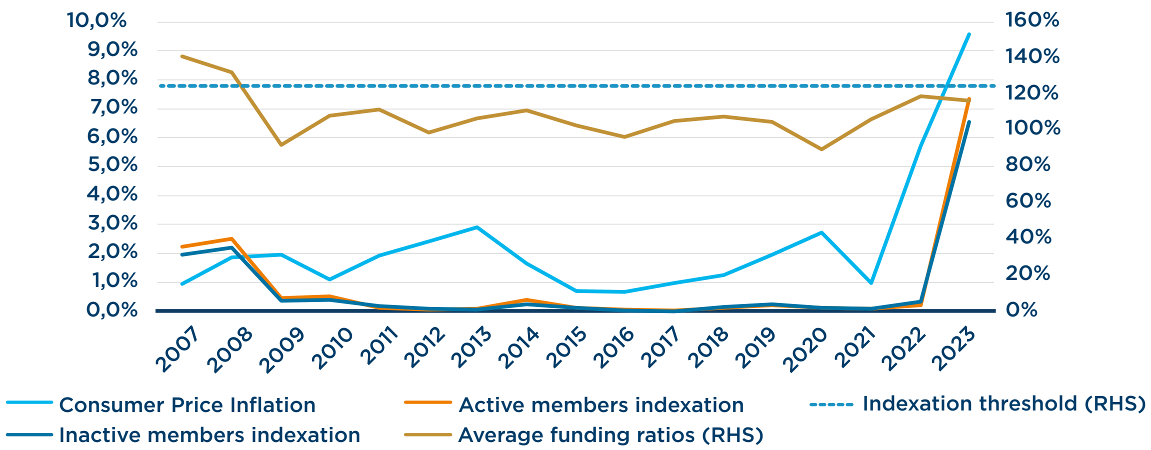
Currently, the most common type of second pillar contract in the Netherlands is the average-pay DB pension contract (88% of market share in 2021[3]). But contrary to the suggestion in their name, these benefits are not guaranteed, but are conditional DB contracts. The actual benefits depend on two factors:

- If funding ratio is above a 110% threshold (i.e. assets are sufficient compared to the current liabilities valuation) the currently accrued pensions can benefit from inflation indexation. Below this threshold, pensions are not indexed (see Figure 1 below).
- If funding ratios fall below a threshold for a prolonged period of time, a recovery plan will be enforced and, as a last resort, accrued pensions can be decreased, even in nominal terms.

Low interest rates led to low funding ratios and challenges for indexed pensions

From 2009 to 2022, following the Great Financial Crisis, the impact on assets and subsequent low interest rates resulted in high liabilities valuations and funding ratios remained very low. Throughout, Dutch pensions have struggled to index pensions (See Figure 1). In the meantime, a series of regulatory changes were undertaken (see Figure 2), while some funds were required to cut their nominal pension temporarily. Ultimately, **long lasting failure to meet the indexation objectives led to disappointment, and motivated the current reform**. Ironically, this reform has been voted in as inflation indexation has resumed, mainly due to the higher interest rate environment, which could have solved part of the current problems.

Figure 1: Dutch pensions indexations vs inflation



2. Source: Mercer CFA Institute Global Pension Index 2022.
3. Source: CPB Netherlands Bureau for Economic Policy Analysis, Completing Dutch pension reform.

Figure 2: The Netherlands: A timeline of pension reforms

Historically, most Dutch pension plans were designed as final-salary DB plans.

Over the last 25 years, a series of challenges and reforms have fundamentally transformed the structure of the Dutch pension system:

2004 Weakened financial position of pension funds following the dotcom crisis and adverse demographic trends, amongst other factors, led to most pension funds reforming their benefit structures into conditional indexation and switching from final-salary to average-salary DB plans.

2007 **(New Pension Act):** Fair valuation principles were introduced for pension funds to strengthen financial governance, while stricter processes were introduced to restore low funding ratios to sustainable levels.

2008-2013 Further reforms to address impact of the Great Financial Crisis. Pension funds raised contributions and reduced the indexation of benefits. Some 75 funds even had to cut their nominal pensions in 2013.

2015 A new supervisory framework, the Financial Assessment Framework (nFTK) was introduced. The objective was to improve the recovery process of stressed pension funds and smooth potential benefit reductions. Policy changes were successful in limiting the decline in financial position.

2020 Negative interest rates and market turmoil due to COVID-19 aggravated the financial situation for most pension funds. To avoid widespread nominal cuts in pensions, minimal funding was reduced to 90% from 105%

This set of new policies managed to limit the deterioration of pension fund's financial position, but failed to restore their long-term sustainability (financial ratios only recently recovered as interest rates started to increase). Public confidence in the pension system was significantly eroded and ***in 2019-2020, it was agreed to start working on profound structural reforms****.*

Source: Amundi

The current accrual system leads to generational conflicts

In the current Dutch DB system, a given contribution leads to a given pension accrual, **independent of the age of the active member**. The asset base is collective, and not split between generations. The funding ratio constraints ensure sustainability of the system, but may lead to intergenerational transfer. For example, part of the active members' contributions may be used to pay retired members' pensions.

Potential for intergenerational conflict:

- Retired members, especially older ones, are clearly in favour of the maximum increase (i.e. indexation) of pensions, as they are set to benefit.
- Younger members may worry that distributing higher pensions today may consume too much of the collective assets and hinder their own future pensions.
- **Ultimately, younger members felt they were paying for older ones.** They argue that their contributions should bring higher accrual at retirement due to a longer investment horizon and therefore higher cumulated returns on investment.

These intergenerational transfers become even more of a problem as job mobility increases: People could spend their younger working life in a DB system that "penalized" younger members and end their career in a DC system, which is unfavourable for older ones.

These conflicts are rather unusual for DB schemes, and are more characteristic of pay-as-you-go pension systems. The pension reform is designed to settle these intergenerational disputes, **by explicitly assigning part of the assets to each individual member**.

The new system

The accrued pension system is no more. Assigned share of assets for everyone

Pension rights will no longer be reported to active members as accrued future benefits, but as a share of assets in their personal pension account. **Each member will have a certain fraction (in Euros) of the total assets**, which can be viewed as an invested lump sum. The pension fund can put in place a solidarity reserve to share the investment risk across generations.

Pension levels will **no longer be guaranteed, even conditionally**. Retirees will receive **a variable annuity, depending on the performance of the assets** dedicated to their age cohort, unless they opt for a pension explicitly guaranteed by an insurer. In the latter case, the pensioner's assets will be transferred to the insurer, who will hold the guaranteed annuity on its balance sheet.

In the new system, members will know how the amount they contributed has been invested, and how that money performed. This will end the intergenerational debates. The new system will be based on two potential options shown in Figure 3 below:

Figure 3: Options to replace DB schemes in the new setup

Regime type	Solidarity reserve?	Investment choice	Pension at retirement
Solidarity pension scheme	Yes, minimum 5% of the assets	No choice, but option to differentiate investment profile based on age	Variable annuity
Flexible pension scheme	Risk-sharing buffer	Choice between several profiles, which also take the age into account	Variable annuity, with the option of fixed annuity

Source: Amundi

Current pension rights will be converted

Since 2008, the cost of low interest rate regimes for both corporate and public DB pensions across the globe has led to a **growing move from DB to DC** . However, these transitions have usually been implemented by closing the DB plan to new members, with current members often unaffected. Existing rights have not been converted, only future contributions. In some instances, members could decide to voluntarily switch their DB pension rights to DC.

The Dutch case will go one step further and convert the current DB pension rights into DC pension assets without approval from individual members. Only the collective agreement from social partners, pension boards and the regulator is needed. Nevertheless, if the effects of the conversion are deemed unbalanced, past accruals may be exempt from transition into the new system.

During the transition, pension funds will need to convert accrued pensions rights into lump sums, as the asset has to be divided between members. This may introduce very lengthy debates, in particular concerning generational issues.

The transition schedule is very tight: Pension funds must submit their transition plan to the regulator before January 2025. Transition must be effective before January 2028, including resolving all the potentially costly administrative and operation transition issues.

How could the reforms impact pension asset allocation?

Theoretically, the optimal portfolio allocation of a DC plan should not differ substantially from a DB plan. In both cases, the purpose is the same: To maximize the expected level of pension, while minimizing their volatility. However in one case the **risk is borne by members rather the pension plan** itself. In the case of loss due to adverse markets, for a DB plan this would mean the absence of indexation, leading to the need for additional contributions and a decrease of nominal pension as a last resort. But, for a DC plan, it would likely mean a decrease in expected pension.

Risk management techniques applied for Liability Driven Investment principles still make sense for DC plans. The value of an annuity heavily depends on the interest rate levels, and hedging this sensitivity to interest rates can heavily reduce the volatility of the expected pensions, even at an individual level.

• For Solidarity pension schemes: Lower risk aversion as guarantee ends

The end of the conditional guarantee changes the perception of risk, which may in turn affect the risk aversion of the decision makers. Nonetheless, if investments are separated according to age cohort, demographics could have an influence on the exposure to growth assets, as younger members will be more invested in equities.

• Switch from DB to flexible or individual DC will change the investor profile, especially in the case of individual DC

If a DB plan chooses to transition to a flexible or individual DC, the ultimate investment decision becomes the members'. **Without a high-level of education and knowledge of financial markets**, they may not understand the added value of interest rate hedging in terms of risk mitigation, especially if it involves complex instruments such as derivatives.

• Some hedging needs transferred to insurers

All in all, depending on the situation, pension fund hedging needs would either decrease or be stable. But, pensioners' liabilities may also be transferred to insurers (via buy-in or buy-out), which could mean an even stricter hedging policy over their assets.

• Possible impacts on the markets

The current assets in Dutch DB schemes is approximately €1500bn, with 47% allocated to bonds (34% denominated in Euros and 13% in other currencies)[4]. The duration of the total pension assets is 8 years, partly bonds and partly interest rate derivatives. ESMA reports[5] that more than half that duration is due to derivatives. In the long term, if half of this derivative exposure is abandoned by pension funds, it would be equivalent to selling €400bn of a standard EMU government bond index in terms of duration (i.e. around 6% of the total value of the EMU government bond index, which at present has a duration of 7.3). A reduced need for hedging means fewer buyers of receiver swaps and fewer buyers of bonds, and will have an impact on the interest rate and asset swap curve.

A new model for European pensions?

The future Dutch pension system paves **a third way between the DB and individual DC models**. It aims to keep some degree of solidarity and protection, while abandoning the constraints of guaranteed benefits. **This system may become an inspiration for corporate and public pension funds who would like to move away from DB. Furthermore, if Dutch pensions overcome the administrative, social and organizational hurdles during the transition period, they will show that in some cases, even acquired DB rights can be collectively transformed into a DC framework.**

4. Source: DNB, https://www.dnb.nl/en/statistics/
5. Source: ESMA, Report on the Central Clearing Solutions for Pension Scheme Arrangements (No. 2), December 2020.

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2020s vs 1970s: Plenty of echoes, but no replay

Our view that the 2020s could bear similarities with the 1970s, which was reinforced by the Covid crisis and the Russia-Ukraine war, has gained more traction since 2021, primarily due to high inflation.

While the 1970s were followed by structural economic changes that included triumph of supply-side economics, globalisation and a shift of value added in favour of capital, there is now a widely shared narrative that **incoming transformations will go the opposite way**.

Despite near-term worries, **inflation remains less persistent than during the early 1970s**. From a cyclical point of view, it is likely to return more easily to levels closer to targets, especially because monetary policy has been more decisive.

Longer term, while arguments in favour of a change in macroeconomic regime abound, both inflation and growth are likely to be caught in a **tug-of-war between opposite forces**. There is still uncertainty on the end game, but we expect high volatility in the global cycle, related to growth and inflation, due to challenges such as the energy transition and the net zero pathway, as well as some forces in developed economies to gain more strategic independence.

Figure 1: A regime shift vs the past decade, still including some 70s features

	1970s	2000-2020	2020s
ECONOMY	Capitalism Crisis Great Inflation	Financial capitalism Deflation Peace, limited geopolitical hotspots Globalisation Inequality increasing	Sharing of value added more in favour of wages? High cyclical inflation followed by structural inflation higher than 2000-20 A new era of geopolitical risk Regionalism, US-China blocs Inclusion taken seriously
MARKETS	Value Energy Cash, Gold, Real assets Dollar devaluation	Large caps Growth Tech Asset inflation Govies & Credit DM favoured vs EM Dollar hegemony 60-40 paradigm	Equal weight - no mega caps Value Financials and green tech Cash, Govies, EM bonds EM favoured vs DM Dollar Status Questioned 60-40 reloaded with real and alternatives assets and commodities

Source: Amundi Institute

Will the 2020s be a rerun of the 1970s?

Following the trigger of the Yom Kippur war (a parallel to Ukraine) and the lagged effect of monetary and/or fiscal profligacy to fund pre-1970s policies and post-war reconstruction, the 1970s began with a sharp surge in inflation. What followed was a decade of volatile and sometimes very high inflation, only tamed by a complete revamp of monetary policy frameworks, ultra-high interest rates and a sharp recession in the US. The years that followed also saw a paradigm change for supply-side economics (deregulation, offshoring and deindustrialisation).

This leads to the questions of whether today's high inflation will be as painful and whether we should expect another paradigm shift in the global economy.

The two scenarios show some key differences:

Inflation	First of all, inflation in 1970s was higher and more persistent, while in 2020s we experienced double digit inflation very briefly. Furthermore, the causes behind 70s' inflation were also more structural, e.g. the end of the Bretton Woods framework.
CBs' response	Like in the 70s, the CBs' reaction has been strong and energetic (omitting the initial period to H1 2022), but, unlike then, now CBs seem to be determined to remain hawkish as long as it is necessary.
Price-wage loop	A price-wage loop in the labour market seems unlikely this time, as there has not been any increase in real wages and given the much more flexible structure of this market compared to the 70s.

A tug-of-war between opposite forces

Less persistent inflation could still trigger more financial, as well as macroeconomic, volatility. This is largely due to the much higher leverage than the 1970s', both public and private. High debt levels mean that governments will be more constrained in how they can respond to economic shocks. Debt-related public or private financial accidents cannot be ruled out as a lagged effect of the recent rises in rates. Moreover, asset valuations have sharply readjusted (namely bonds), or may still need to following the higher rates (i.e. some illiquid assets).

- **Inflation** - Globalisation was often said to be the cause of the lowflation of the last decades. However, deglobalisation may prove to be more growth-negative than inflation-positive, even with a prolonged and gradual negative supply shock. How deglobalisation will proceed (if at all) remains in question. Goods are now a much smaller share than services in inflation baskets, with new technologies potentially leading to a deepening of globalisation within services activities. Other long-term inflationary factors include expected large investment plans for goals such as strategic autonomy in key sectors, climate change, or reducing social inequalities. However, the extent these changes are structurally inflationary will largely depend on how they will be financed: long-lasting accommodation from Central Banks or financing through tax increases.
- **Growth** - Higher appetite for investment may be a clear positive for growth. Theoretically at least, this is the ideal blend of higher demand and productivity growth. However, investment plans could fall short if bogged down in conflicting priorities, red tape and resistance from vested interests. Moreover, some forces of secular stagnation are still present (declining growth in productivity and in the working age population). More frequent and intense episodes of climate change and geopolitical disruption can also amplify these forces and hurt growth.
- **Value-added** - Policies aimed at calming fatigue towards supply-side economy and the rise in non-conventional political forces may lead to a rebalancing of value added towards wages (with uncertain implications on growth speed). In contrast, accelerating new technologies, while benefitting a minority, could make the majority of workers even less marginally productive and shift the value added further in favour of capital.

Likely features of the new regime:

- Mildly higher structural inflation (CBs simply reaching their targets, instead of the frequent 2000-20 undershoots)
- Gradual extension of de-globalisation
- Growth rates similar to the previous decade
- Slightly higher share of pie towards wages at expense of capital

New tools to navigate a more uncertain environment

Pension funds should be aware that the path towards a new regime will not be linear. An investment framework able to capture higher volatility in growth and inflation and adapt asset allocation decisions to different regimes will be needed.

It will be important to enhance diversification:

- **Short term;** the risk of a reacceleration in inflation is moderate, but volatility of inflation figures will likely remain high as multiple adjustments occur. From a growth and income perspective, **our cyclical view remains cautious**. We see some cracks in the real economy due to tighter financial conditions (commercial real estate and highly leveraged companies), while equity markets are too buoyant. Therefore, we remain cautious on risk assets. A dynamic asset allocation approach, that detects inflation points in the cycle, would help re-adjust portfolios.
- **Longer term;** slightly higher structural inflation (vs. 2000-20) means **more frequent co-movement between bonds and equities**, something already illustrated in a spectacular way in 2022 (the worst year for a balanced portfolio since 1974, according to some metrics). **Investors should therefore seek diversification**, recalling that in the 1970s most asset classes delivered negative real rates, with the exception of commodities like gold and oil.

A retreat of globalisation or regionalisation, even limited, is likely to lead to less synchronized economic cycles and monetary policies across major economic regions, and thus more value for regional and currency diversification. Continuing emerging market growth outperformance, could lead to emerging market assets outperforming developed.

Rebalancing towards wages would mean margins representing a smaller share of value added, at least in developed markets. **Pension funds should not expect the same ROEs on developed market equities** with an equivalent level of risk. With a longer-term view, combined with the likely implications of the energy transition (impact on growth differs according to country), investors will need to include **real, alternative and emerging market assets** to achieve the same returns as in the past decades.

Click here to read the full paper

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Pension funding ratios: so far, so good

The first half of this year has shown rather positive developments for pension funds: growth assets such as equities showed a solid performance, while interest rates remained at high levels with lowered volatility. On average, this led to an increase in funding levels.

	31/12/2018	31/12/2019	31/12/2020	31/12/2021	30/06/2022	30/09/2022	31/12/2022	31/03/2023	30/04/2023	31/05/2023
Netherlands	103.60%	104.30%	100.20%	114.30%	122.40%	124.62%	115.79%	116.4%	117.3%	117.8%
UK	95.70%	99.20%	95.50%	107.70%	120.10%	137.56%	136.47%	133.25%	136.14%	139.7%/ 145.2%[6]
US	86.10%	86.80%	87.90%	95.50%	94.40%	95.80%	98.20%	98.50%	98.30%	99.00%
German CTA	67.30%	67.90%	69.10%	77.00%	90.70%	91.70%	92.00%	93.80%	92.00%	92.7%

Sources: UK data: Purple Book, PPF S179 funded status. Netherlands data: Dnb. US data: Aon Pension Risk Tracker. German CTA data: FactSet, based on average pension exposure of German corporates of EUROSTOXX 600 for 31/12/18 until 30/12/20. Amundi estimate from 30/12/21.

2023 Market Context

The first quarter of the year was a volatile period for markets and despite the turmoil in the banking sector, **the large majority of assets advanced** with gains in equities, sovereign bonds, credit and EM assets, with the only exceptions being commodities, which lost ground in every month of Q1, and the US dollar. Even in March, after the collapse of the Silicon Valley Bank and the purchase of Credit Suisse by UBS, government bonds rallied and led to a rally in equity markets, particularly growth stocks.

The second quarter of the year started well in April, with the large majority of assets advancing as **volatility generally fell and worries about the US bank sector somewhat eased off**. In terms of macro backdrop, economic data continued to remain on the upside in all major regions and the latest data continued to show that inflation remained resilient in the US and was strong in Europe and the UK. Overall, the **positive economic momentum supported risky assets and the lack of major developments allowed calm to return to markets**. On the other hand, expectations that the Fed will announce another rate hike at their May meeting and concerns about the US debt ceiling deadline have been factors keeping returns muted.

May was a difficult month for several asset classes and it was marked by various factors: concerns about regional banks emerged once again, accompanied by another rate hike from both the Federal Reserve and the European Central Bank, whilst negotiations around the US debt ceiling added to market uncertainties. This downward trend was evident across commodities, which reached their lowest levels in nearly two years. Additionally, global bonds and equities recorded losses in aggregate. However, there were a few notable exceptions, particularly in the tech sector with enthusiasm surrounding the potential of artificial intelligence.

In June, equity markets showed a very solid performance (+4.7% for the MSCI world), in particular in the US and Japan. Interest rates generally increased, with a very mild increase in the Eurozone (15Y swap was nearly unchanged), a more material one in the US and the UK (+20bps for the 15Y swap) with a strong increase on the short end of the curve for the latter.

6. Funding ratio has increase due to a new set of assumption in the s179 norm. Here we give the funding ratio with the former and new set of assumptions.

Impact on pension funds

Interest rates generally decreased during the first quarter: A downward movement in January was erased by an equivalent rise in February. In March, US yields fell again: the 15Y US Swap rate fell from 3.86% to 3.46% (-40bps). Meanwhile, the Euro 15Y swap rate dropped from 3.18% to 2.98% (-20bps). In equity markets, after a soar in January, (+7.08% for MSCI world Equity index), February saw a modest decrease (-2.40%) followed by a rebound in March: the MSCI World Equity index advanced by +3.1% despite the volatility and the serious difficulties within the financial sector. **The combination of a positive impact from equities and a negative one from interest rate decreases** due to increases in liability valuations, **meant the effect on the funding ratios was mixed**. Nevertheless, the equity rally tended to dominate and **funding ratios mildly improved on average** in most countries in Q1, with the exception of the UK.

In the second quarter, equities where generally positive. After a modest increase in the two first months (+0.75%) equities jumped during the first half of June. The interest rate curves remained inverted, with the 15Y swap rate nearly unchanged in Europe (-5bps), increasing moderately in the US (+22bps) and very significantly rising in the UK (+66bps). **The combination of positive equity performance and increasing or steady discounting rates led to a modest improvement of the funding ratios** in the US and the Netherlands. In the UK, these ratios took off due to the positive alignment of every factor: positive equity performance, a higher liability discount rate, as well as a new set of actuarial assumptions used for the s179 liabilities valuation. These new assumptions introduce changes in the discount rate references, that pushes the average funding ratio by 5.5%, on top the 6.5% increase due to market effects mentioned above.

CROSS ASSET Investment Strategy

CENTRAL & ALTERNATIVE SCENARIOS (12 TO 18 MONTHS HORIZON)

	DOWNSIDE SCENARIO (Prob. 20%) Recession in DM	CENTRAL SCENARIO (Prob. 70%) Persistent stagflation, reassessment of risk premiums	UPSIDE SCENARIO (Prob. 10%) Economic resilience
Geopolitics	■ Worsening Ukraine war impairs commodity trade. ■ More protectionism and increased retaliation to protectionist measures.	■ Ukraine-Russia: risk of escalation in the short run, but de-escalation still likely in late 2023-early 2024. ■ China-US tensions. ■ More protectionism, near-shoring / friend-shoring. ■ OPEC+ imposing a floor on oil prices.	■ De-escalation / ceasefire in Ukraine. ■ Lower energy or food prices.
Inflation and policy mix	■ Sticky core inflation leads to tighter financial conditions. ■ CB hike more than expected. ■ Financial stress. ■ Two sub-scenarios with different paths for key rates: modest recession: inflation risks may still prevail; and strong recession: large rate cuts as soon as H2 2023.	■ Inflation to slow gradually; sticky core inflation, should approach target by end-2024. ■ DM CB close to peak, no rate cuts in H2 2023. ■ Fed Funds rate back to 3% by end-2024 (-225bp) on the back of a significant disinflationary trend expected in 2024. ECB: no cuts before mid-2024. ■ Many EM CB have hit peak rates. Rate cuts expected in some countries, particularly in LatAm. ■ EU fiscal policies to tighten. US fiscal impulse more ambiguous: the IRA is positive, but spending caps (debt ceiling deal) are negative. EM fiscal space constrained amid prudent stance. Fiscal stimulus coming up in China to avoid a downturn.	■ CB status quo, key rates higher for longer.
Growth path	■ More widely spread recessionary outlook (global growth below 2%).	■ Subdued global growth (below 3%), with divergences: anaemic growth in Europe, shallow US recession from Q4 2023, marked slowdown in China. ■ Tightening credit conditions to hit DM economic activity in H2 2023. ■ Growth gap still tends to favour EM in 2024.	■ In case of pronounced cyclical disinflation, we could see a faster-than-expected return to potential growth in 2024. ■ IMF- or ECB-type scenario.
Climate change	■ Climate transition measures postponed: more climate events hitting supply chains or food security.	■ Climate change hampers growth and exacerbates stagflationary trends.	■ Climate change policy and energy transition are top priorities and coordinated across regions.

RISKS TO CENTRAL SCENARIO

HIGH ← PROBABILITY → LOW

Market Impact	25%	20%	20%	20%
	Geopolitical risk and war escalation	Global economic slowdown and deep profit recession	Persistent stagflationary pressure (US / Europe)	Macro financial risks triggered by tighter credit and liquidity conditions
+	**Positive** for DM govies, cash, gold, USD, volatility, defensive assets and oil.	**Positive** for cash, JPY, gold, quality vs growth, and defensives vs cyclicals.	**Positive** for TIPS, gold, commodity FX and real assets.	**Positive** for US Treasuries, cash and gold.
-	**Negative** for credit, equities and EM.	**Negative** for risky assets and commodity exporters.	**Negative** for bonds, equities, DM FX and EM assets.	**Negative** for credit.

Source: Amundi Institute as of 6 July 2023. DM: developed markets. EM: emerging markets. CB: central banks. USD: US dollar. TIPS: Treasury inflation-protected securities. FX: foreign exchange markets.

CROSS ASSET Investment Strategy
AMUNDI ASSET CLASS VIEWS

	Asset Class	View	vs. M-1	Rationale
EQUITY PLATFORM	US	–		A large part of market gains have been driven by a handful of large cap stocks, which have also been boosted by the artificial intelligence wave. We think this has resulted in expensive valuations and is inconsistent with still high inflation and recession fears. We stay defensive.
EQUITY PLATFORM	US value	+		Value is our long term call in light of relatively high interest rates (compared to past decades), leading to a mild increase in yields. But we match that with quality and bottom up selection to understand the underlying business models of our investments.
EQUITY PLATFORM	US growth	– –		Expensive growth stocks could be affected more by slowing economic growth, which could lead to declining liquidity. At the same time, if recession risks fade (not our central case), Fed tightening could affect the high duration tech stocks. We avoid this part of the market.
EQUITY PLATFORM	Europe	–/=		We are seeing signs of markets pricing in a slowdown but select soft data and recent earnings have been somewhat encouraging. We stay balanced and cautious, preferring names that can pass on input costs to customers without compromising on volumes.
EQUITY PLATFORM	Japan	=		Sentiment improved recently, led by improving domestic activity, yen movements and higher inflation. But we are vigilant on slowing global growth's effect on Japanese exports.
EQUITY PLATFORM	China	+		We foresee a moderate economic recovery characterised by targeted government support. While consumption data could come in weak, select opportunities remain around the Covid 19 rebound and we prefer the onshore markets amid potential geopolitical risks.
EQUITY PLATFORM	Emerging markets ex China	=		In a diverging EM world, we see attractive valuations and potential for earnings recovery. Upward trends in earnings recovery should continue in EMEA and Asia based on resilient growth trends compared to developed economies. In particular, we like countries such as Brazil, Vietnam and Indonesia, but are cautious on Thailand, Saudi Arabia and Malaysia.
FIXED INCOME PLATFORM	US govies	=/+		Some strong economic data and still high inflation recently have led to a move up in core yields but our recession call remains in place, even if it is slightly delayed. We remain slightly positive and flexible in light of high volatility and policy ambiguity.
FIXED INCOME PLATFORM	US IG corporate	=/+		We are mildly positive on account of attractive carry, strong balance sheets, and an active primary market that could present opportunities. However, potential liquidity risks lead us to stay selective. At a sector level, we like financials.
FIXED INCOME PLATFORM	US HY corporate	–		Restrictive real rates, tightening financial conditions, and deteriorating cash flows could worsen the default outlook for low rated companies. Such companies may be unable to access financing if earnings situations worsen.
FIXED INCOME PLATFORM	European govies	–/=		Persistent core inflation and our expectations of policy tightening by the ECB lead us to be slightly cautious on core Europe duration. But we are carefully assessing the ECB's stance and inflation in order to ascertain our move to neutrality.
FIXED INCOME PLATFORM	Euro IG corporate	=/+		Our stance of cautious optimism remains as we do not expect a significant slowdown in the IG market. But a deteriorating global economy could put pressure on Europe and affect spread volatility. Companies with robust internal cash generation should do well.
FIXED INCOME PLATFORM	Euro HY corporate	–		We see potential for a wider spread widening in the highly leveraged, low rated segments of the markets, particularly when earnings come under pressure. This could exacerbate the potential liquidity crunch for companies most in need.
FIXED INCOME PLATFORM	China govies	=		China's decoupling from developed markets provides diversification opportunities but we are monitoring the evolution of policy and fiscal stimulus in the country.
FIXED INCOME PLATFORM	EM bonds HC	=/+		HC bonds provide attractive yields, particularly in countries like Brazil, Mexico and Indonesia. We like HY over IG, given attractive spreads in the former, but selection is key Corporate debt in HY is another area we are exploring.
FIXED INCOME PLATFORM	EM bonds LC	+		We remain constructive on LC debt which could be supported by a general weakening dollar trend this year. But selection is important. We are positive on countries like India, Romania and Mexico, and favour countries offering good quality of carry.
OTHER	Commodities			Slowing demand concerns are not reflected in oil prices yet despite production cuts extension by OPEC+. Markets await further signals before prices move up. Our Brent price target is kept around \$90/bbl towards end-H2 2023. We see modest upside on gold to around \$2,050/oz but volatility would remain high as Fed moves close to a pivot.
OTHER	FX			Recent USD upside seems temporary, led by economic surprises, but falling inflation should allow the Fed to respond to recession. USD should depreciate this year as its high rates advantage fades. We keep our Q1 2024 target for EUR/USD at 1.18.

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Negative view   Neutral   Positive view

▼ Downgrade vs. previous month

▲ Upgraded vs. previous month

Source:Amundi, as of June 2023, views relative to a EUR based investor.
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To go further: The Amundi Research Center

Amundi Institute

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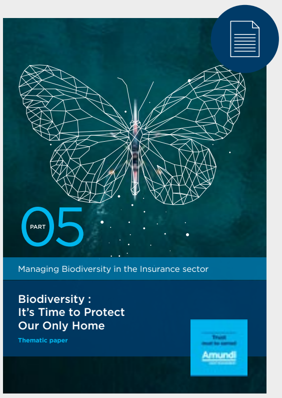
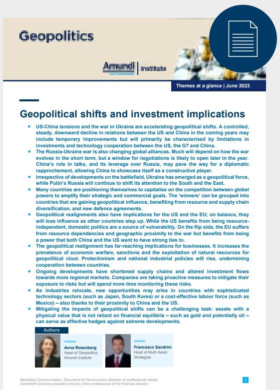
ESG and Net zero



Mid-year Outlook

Thematic Papers



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