## CENTRAL & ALTERNATIVE SCENARIOS

**Monthly update**

We keep probabilities unchanged but we "darkened" and detailed the narrative in our different scenarios

### DOWNSIDE SCENARIO Stormy waters

**30%**

- **Faltering effort to restart Chinese growth:**
  - Spill over to the banking sector and exacerbation of financial risks
  - Rising default rate due to global recession and risk of financial instability
  - Asia ex-China has limited ability to implement policy measures (second-round effect recession in the region)
- **Covid-19 spreading fast in the RoW:** Market re-assessment of risks leading to tightening in financial conditions
- **Emergency funding** (liquidity injections) triggered by policies to reduce the pressure on monetary policy, lead to debt unsustainability
- **Relocation and replacement of supply chains:**
  - Lower trend growth in China
  - Global recession due to a globalisation unwinding
- **Trade war escalates** and results in a deeper contraction in global trade, a manufacturing slump (with spillover to services) and a currency war
- **Exacerbation of idiosyncratic risks** (Middle East, Hong Kong, US elections, Brexit and Italy)

### CENTRAL SCENARIO Hope it's a U

**55%**

- **Temporary shock to growth (V or U):**
  - The coronavirus impact proves "short lived" (H1)
  - The shock might be deeper than expected in the short run, but we stick to the view that it doesn't impact potential growth
  - Subsequently, we expect a progressive catch up in H2 followed by a stabilisation at potential
- **Low rates, low inflation, low single-digit profits growth** for corporates
- Record **high debt** (public and corporate)
- Prominent **geopolitical** dimension (watch US elections in particular)
- **Monetary and fiscal policy** combination mitigate trade uncertainty and manage coronavirus implications

### UPSIDE SCENARIO Shine on risk assets

**15%**

- **Smart and robust packages in China** leading to a rebound of global growth
- **Monetary and fiscal policy support** (Europe/Germany, and possibly the US too) + **positive impact coming from the past policy mix**
- **Europe: significant progress on the financial architecture** (capital market union, banking union, flexible fiscal rules)
- **True de-escalation** between China and the US **with a meaningful Phase 2 trade agreement**

### Where do we stand on Covid-19

- COVID-19 outbreak is a temporary but profound shock on Chinese economy (Q1), and contained spillover to trade partners in Asia and supply chain shortages globally at least short term.
- The Chinese economy will contract in Q1 and should then rebound, but how quickly and how fast remains uncertain. Watching data on energy consumption (coal), trade and PMIs is more crucial than forecasts. In our central scenario, we assume the Chinese government is attempting to offset COVID19 with easier policies, resuming normal production capacity in Q2 and will focus on continuity, social stability more than growth targets. We believe this recovery path from Q2 is our major call.
- We expect a downturn in global trade, affecting industrial production and manufacturing. Countries such as Korea, Japan and the Eurozone are the most vulnerable. We also expect a drop in global confidence (PMI Global Manufacturing).
- More recently, the COVID19 out-broke on a larger geographical scale. The impact is a demand/supply shock, internal and external and lastly involving both manufacturing and services sector endogenously at country level. This leads to higher recession risks.
- Longer term, the coronavirus will incentivise western multinationals to significantly reduce the Chinese labour forces, eventually triggering insourcing from China. Therefore de-globalisation faces a renewed spin, and financial markets will provide a premium to countries that are able to adjust and "self-help" themselves faster than others.

## TOP RISKS

### ECONOMIC RISK

**12%**

Probability

#### China / Asia growth

- **Faltering effort to restart Chinese growth,** spillover to banking sector and financial risk exacerbation, default rate lift landing on **global recession and financial instability.**
- Asia excluding China has **limited ability** to implement policy measures to adjust the cycle back to a virtuous path (recession).
- Debt burden exacerbated by emergency liquidity injection to overcome coronavirus drawdown.

#### DM growth

- **Virus expands globally,** governments seek expansionary policies to offset Covid-19 but it's **chaos leading to recession**

\+ **DM Govies, Cash, Gold, linkers, USD, Defensives vs. Cyclicals**

\- **Oil, risky assets, FX commodity exporters**

### FINANCIAL RISK

**15%**

Probability

#### Market re-assessment of risks

- **Spillovers leading to tightening financial conditions,** PMI faltering to recessionary level generating financial turbulence (market washout) and eventually EPS recession
- Mounting **corporate vulnerability**
- **Credit illiquidity** and risk misallocation
- Drying up of USD liquidity
- Central Banks inefficacy

\+ **US Govies, CHF/AUD, YEN (AUD, NZD, CAD), CDS, optionality, Min Vol**

\- **Oil, risky assets**

### (GEO)POLITICAL RISK

**10%**

Probability

#### Exacerbation of idiosyncratic risks

- US elections
- Germany
- Italy
- Brexit
- Middle East
- Hong Kong
- **Trade war escalates** and results in a deeper contraction of global trade, a manufacturing slump (with spillover to services) and a currency war

\+ **DM Govies, Cash, Gold, linkers, USD, volatility, quality**

\- **Oil, risky assets, EMBI**

## Methodology

- **Scenarios**

The probabilities reflect the likelihood of financial regimes (central, downside and upside scenario) which are conditioned and defined by our macroeconomic forecasts. We use the k-means clustering algorithm to our enlarged macroeconomic dataset, splitting the observations into the K cluster, where K represents most of the variability in the dataset. Observations belong to one cluster or another based on their similarities. The grouping of the observations into the k clusters is obtained by minimizing the sum of squared Euclidean distances between observations and clusters centroids i.e. the reference values for each cluster. The greater the distance, the lower the probability to belong to a given regime. The GIC qualitative overlay is finally applied.

- **Risks**

The probabilities of risks are the outcome of an internal survey. Risks to monitor are wrapped in three categories: Economic, Financial and (Geo)politics. While the three categories are not independent, 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.

## GLOBAL RESEARCH CLIPS

**1** **Corona Virus Outbreak**

- Temporary, albeit profound and impactful, shock to the Chinese economy (4.5% 2020Q1E (was 5.8%) and 5.6% YoY 2020E, was 5.8%), impact on Asian countries primarily regarding exports and tourism. This shock and the bleak tone of hard data (led by Germany) results in slowing global trade dynamics and shift of USD denominated paper. US remains resilient on weaker imports. The shock delays expectations for a global (tactical) momentum.

**2** **PMIs: manufacturing PMI was potentially recovering, but coronavirus impact not yet embedded**

- In the US, the divergence between ISM and PMI narrowed: potential surveys do not fully reflect the coronavirus (surveys conducted in early stages of the news). Progressive recovery in the manufacturing PMI in the Eurozone but still below 50. Negative prints in China might reflect early coronavirus spillover to confidence already in December.

**3** **USD paper attracts investors, but the sharp repricing of fed funds rate expectations and the surge in volatility pushed down carry strategies, thus supporting the EUR.**

- While concerns on global growth still point to a resilient USD, the USD rate advantage is sharply pointing south as the Fed cuts 50bps while ECB is perceived as having less ammunition from a monetary policy perspective. EUR/USD has recovered the loss registered since the end of January, as volatility surged and carry positions have been closed, with funding currencies like the EUR and SEK moving higher vs. the greenback.

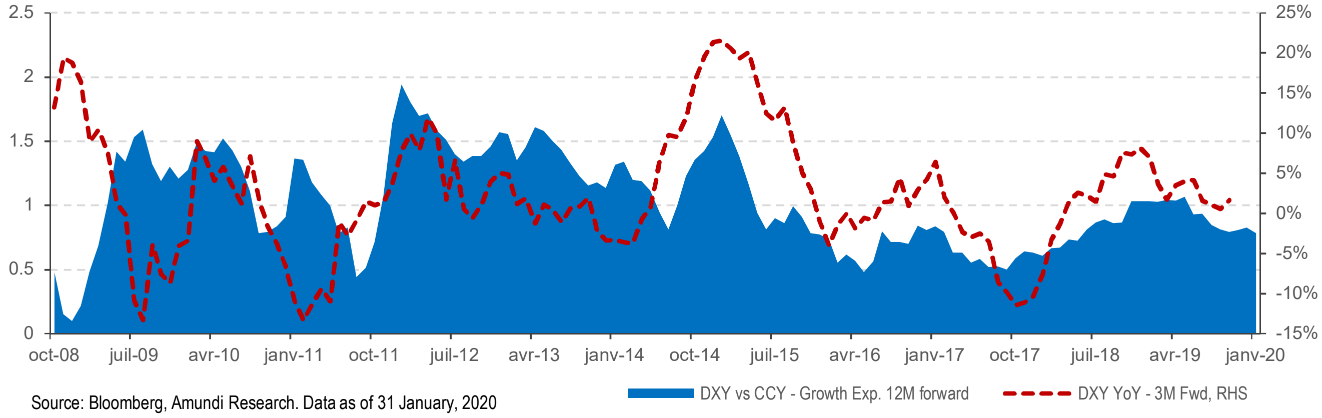
**4** **Global financial conditions corrected lower in response to Covid-19 concerns**

- Global financial conditions tightened in February, with all regions in the "tightening" zone at the end of the month. GEM were the area with the strongest shift in financial conditions, which moved even lower to the levels seen during the summer of 2019. All sub-components moved lower, with the biggest negative contributions coming from stock market volatility, the widening in corporate spreads and USD strength vs. high yielders in the EMFX universe.

### FX under the microscope - what's behind the EUR/USD move?

With the USD trading at a premium on fundamentals, growth is what we need to see investors turning structurally bearish on the greenback. We entered 2020 with signs that the rest of the world (RoW) may have grown at a faster pace than the US, but the temporary, Covid-19-related shock to Chinese economic activity – with its negative spillovers to the RoW – is making this less likely. US assets are looking more attractive at this stage, and the USD safe-haven status, together with the highest carry in the G10 FX space, tends to attract foreign flows during periods of low market volatility like the one we are currently experiencing. Moreover, the USD's positioning is less of a concern than a few months ago, and the possibility of further USD steps higher can therefore not be ruled out. In other words, alternative scenarios need to materialize before we will see investors definitely closing USD longs – the flight to quality will need to dissipate, the policy mix will need to spur growth outside of the US, and the USD carry trade will need to vanish in response to a more aggressive Fed.
While it is true that the sharp repricing of fed funds rate expectations would point to a diminishing USD rate advantage in 2020, and that periods of high market volatility tend to push high yielders lower in response to closing carry positions, with no growth the USD safe-haven status will be predominant in our view, despite high valuations.
In other words, a few conditions will need to materialize before we see investors definitely closing USD longs – the flight to quality will need to dissipate on stabilizing global growth, the policy mix will need to spur growth outside of the US, and the USD carry trade will need to vanish in response to intervention from the FED.

**Growth expectations remain in favour of USD for the time being**




Source: Bloomberg, Amundi Research. Data as of 31 January, 2020

## AMUNDI ASSET CLASS VIEWS

| | Asset Class | View | 1M change | Rationale |
|---|---|---|---|---|
| EQUITY PLATFORM | US | = | | Markets are not pricing in any meaningful election risks, which could come to haunt asset prices in the future and seems too optimistic on the macroeconomic front. US equities should be more resilient in a downturn, but we are overall cautious, and we favour conservative cyclicals in the financial and industrial sectors. |
| EQUITY PLATFORM | Europe | -/= | ▼ | The virus outbreak will delay the expected cyclical recovery and leads to a more cautious approach. Future earnings outlook remains crucial to identifying potential areas of value. We continue to favour cyclical value stocks over expensive growth names, but remain selective. Opportunities to add to good quality names at discounted prices. |
| EQUITY PLATFORM | Japan | = | | Japanese corporates have lower debt and their profits are also growing. However, most Japanese companies are exporters and could be vulnerable to a rising yen, given its safe haven status, amid the spreading risks of the coronavirus and if geopolitical risks emerge. As a result, we remain neutral. |
| EQUITY PLATFORM | Emerging markets | = | ▼ | Attractive valuations relative to the developed markets and expectations of earnings growth should support EM equities, but short term volatility is likely to persist. Here we focus on stories linked to domestic consumption or shifts in value chain (Russia, Indonesia). We are watchful of sectors directly impacted by China tourism and trade. |
| FIXED INCOME PLATFORM | US govies | =/+ | ▲ | From global fixed income perspective, we keep a relative preference for US duration as safe haven demand remain high and CBs stay ready to act in case of deterioration of the scenario. The Fed has already done a step in this direction. |
| FIXED INCOME PLATFORM | US IG Corporate | =/+ | | We remain cautious in light of elevated tail risks to growth that could affect credit fundamentals; we continue to favor securitized credit over unsecured. Structured securities, including non-agency Residential Mortgage Backed Securities (RMBS), consumer debt and auto loans, are attractive relative to most other IG sectors. In agency MBS, although spreads are increasingly attractive, the 'net supply' impact from Fed's dwindling agency MBS holdings will likely hamper the potential for near-term spread tightening. |
| FIXED INCOME PLATFORM | US HY Corporate | = | | We are cautious in HY amid leverage risks and higher risks linked to the coronavirus outbreak. Liquidity could also deteriorate in case of further market risk off. Selection is key to avoid areas potentially at stress. |
| FIXED INCOME PLATFORM | European govies | -/= | | We don't see value in EU core govies. We have a constructive view on peripherals, especially on Italy, although we are mindful of the potential volatility due to the spread of the coronavirus in the country. Further spread widening is in our view an opportunity to add Italian debt in European fixed income portfolios. |
| FIXED INCOME PLATFORM | Euro IG Corporate | ++ | | EUR IG remains attractive relative to the US, and would also benefit from ECB's quantitative easing program. In this regard, the subordinated debt financial sector remains our top pick. Short-term volatility provides opportunity to add to this asset class, with a selective approach. |
| FIXED INCOME PLATFORM | Euro HY Corporate | + | | We remain contructive on EUR HY. However, idiosyncratic risks are increasing and we are selective. |
| FIXED INCOME PLATFORM | EM Bonds HC | + | | We are positive on EM debt as favourable technicals, monetary policy easing and fiscal stimulus should outweigh the coronavirus impact and volatility from US elections. We prefer countries such as Indonesia, Ukraine and S. Africa. |
| FIXED INCOME PLATFORM | EM Bonds LC | = | | Valuations in LC debt are less attractive and we could also see some negative impact from currency weakening. This is particularly true for commodity-exporting countries and those which are more exposed to a Chinese slowdown. However, there are some pockets of value, especially in frontier markets. |
| OTHER | Commodities | | | Commodities remain relatively cheap, due to easing financial conditions and decent economic growth despite recent concerns related to the coronavirus. We remain constructive on gold in 2020, as we think these drivers will underpin demand for precious metals. Gold also looks the most efficient hedge to several risks. However, base metals are likely to suffer from the global economic slowdown. For WTI, we recently revised down our target range to \$50-\$60/bbl and for Brent to \$55-\$65, due to recent cuts in oil demand as China contribution is expected to decrease dramatically in the short run. However, OPEC should remain vigilant and very active on output cuts, mitigating external shocks if required. |
| OTHER | Currencies | | | Our 12M target for EUR/USD remains around 1.14 and we believe there are asymmetric risks in favour of the EUR. However, for the time being, the virus threat in Europe, and weak Italian production and investor sentiment could weigh on the EUR. At the same time, the USD is expected to remain resilient as concerns on global growth are not expected to dissipate soon. We keep our USD/JPY target at 104 and believe JPY is cheap relative to its medium-term fundamentals and so is GBP. We maintain our cautious view in aggregate on EM FX. |

**LEGEND**

| --- | -- | - | = | + | ++ | +++ | ▼ | ▲ |
|---|---|---|---|---|---|---|---|---|
| | Negative | | Neutral | | Positive | | Downgrade vs previous month | Upgraded vs previous month |

Source: Amundi, as of 2 March 2020, views relative to a EUR-based investor. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research, investment advice or a recommendation regarding any fund or any security in particular. This information is strictly for illustrative and educational purposes and is subject to change. This information does not represent the actual current, past or future asset allocation or portfolio of any Amundi product.

IG = Investment grade corporate bonds. HY = High Yield Corporate; EM Bonds HC / LC = EM bonds hard currency / local currency. WTI= West Texas Intermediate. QE=quantitative easing.

Amundi ASSET MANAGEMENT | Research & Macro strategy

# CROSS ASSET
INVESTMENT STRATEGY

March 2020 #03

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