CENTRAL & ALTERNATIVE SCENARIOS (12 TO 18 MONTHS HORIZON)

Monthly update

We have reviewed the content and probabilities of our scenarios. First of all, we have included in our central scenario some of the risks that are materialising (e.g. stagflation in Europe) and that were previously included in our downside scenario. Against this backdrop, the probability of this scenario increases (from 60 to 70%). The downside scenario is also becoming much darker (global recession /debt crisis). And it is now counterbalanced by a new upside scenario, that of a rapid decline in inflation due to an easing of gas prices.

DOWNSIDE SCENARIO 15%

Deep global slump

Analysis

- Worsening/expanding **war in Ukraine**
- Energy crisis and **deep recession in Europe**
- **Covid-19 resurgence**
- **De-anchoring of inflation expectations,** disorderly adjustments by CBs
- **Recession in China**
- **Global economic downturn** with, in a second stage, renewed deflationary pressures
- **Global financial crisis/debt crisis with several EM defaults**
- **Governments fail to implement countercyclical fiscal policies.** Decisive action on financial repression
- **Climate transition measures postponed**

Market implications

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

CENTRAL SCENARIO 70%

A stagflationary episode, with rising divergences

Analysis

- **Stalemate in the war in Ukraine**
- **Confidence shock in EU,** due to high energy prices
- **Covid-19** is an endemic disease
- **Inflation fails** to return to CB targets by 2024
- Global **nominal GDP growth to trend higher,** mitigating the impact on earnings
- **Growth divergences:** recession in the EZ/ UK, sluggish rebound in China, sub-par growth expected in the US (well below potential in 2023)
- **CBs divergences:** Fed to continue its tightening cycle but adopting a dovish stance (end of Q4); BoE on a soft hiking cycle; ECB to raise rates, and activate the TPI; PBoC in easing bias
- **Divergent fiscal policies:** mild expansion in the EU; restrictive in the US in 2022-23
- **Climate change** disrupts the commodity cycle and adds to stagflationary trends

Market implications

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

UPSIDE SCENARIO 15%

Inflation falls back quickly, ending the stagflationary episode

Analysis

- **Ukraine war** ends and **sanctions** are withdrawn gradually.
- **Russia maintains gas supplies,** commodity market normalises
- **Covid-19** recedes
- **Inflation falls back quickly,** supply bottlenecks ease
- **Recession fears dissipate** and inflation remains under control which eases the pressure on CBs
- **Lower uncertainty,** extra savings and renewed purchasing power can fuel consumption and investment in DM without erosion of corporate margins
- **Fiscal discipline** gradually restored
- **Climate change** policies and energy transitions become first priority

Market implications

- US Treasuries curves bear steepen
- Favour risky assets with cyclical and value exposure
- Favour linkers and equities 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 keep the same probabilities for the three families of risks. We see risks growing on all fronts, closely linked to each other. Economic fundamentals are deteriorating globally (which is reflected in the central scenario). The course of the war in Ukraine and its potential implications can tip the scenario in either direction. We consider Covid-related risks (including lockdowns in China) as part of the economic risks.
Risks are clustered to ease the detection of hedging strategies, but they are obviously related.

ECONOMIC RISK 30%

- **Global recession** driven by an oil/gas shock, a tightening of monetary conditions and a loss of purchasing power
- **The *weaponisation* of gas supply** by Russians could cause a **severe energy crisis in Europe,** leading to a **deep recession** (confidence shock)
- **Economic crisis in Eastern Europe** following a collapse of the Russian economy, elevated energy prices, uncontrolled inflation and a migrant crisis
- Disorderly adjustments by CBs, which underestimate the supply driven inflation and lose control
- **Global profit recession** triggered by the global slowdown coupled with persistent input-cost pressures (margin compression)
- **Recession in China.** Zero Covid policy combined with a housing crisis spiralling out of control
- **End of the great coincidence:** with the persistence of stagflationary pressure, CBs and governments' objectives are no longer fully aligned: the room for countercyclical fiscal policies is reduced
- **Pandemic**
  - Risk of a more dangerous and vaccine-resistant variant
  - New lockdowns or mobility restrictions
- **Climate change-related natural events** hurt growth visibility and social balance

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

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

FINANCIAL RISK 30%

- **Sovereign debt crisis**
  - An extended war in Ukraine would hurt DM vulnerable public finance with public debt ratios already at historically high levels
  - De-anchoring inflation expectations could lead to harsher monetary tightening and a bond market dislocation
  - Most countries are vulnerable to rating downgrades and rising interest rates
  - EM weaknesses could also face a balance-of-payments crisis and increased default risks
- **Corporate solvency risk increases,** amid deteriorating fundamentals, rising uncertainty and corporate margins 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
- **Currency wars:** currency appreciation is a way for CBs to fight inflationary pressures

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

- Oil, risky assets, frontier markets and EMs

(GEO)POLITICAL RISK 30%

- **War in Ukraine**
  - Prolonged military struggle leading to high intensity conflict and potentially to a western military confrontation
  - High risk of accident at nuclear facilities in Ukraine
  - [That said, it is possible that in the coming months the situation will calm down, paving the way for a resolution/cease-fire]
- **EU political fragmentation** or 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. Risk of accidental confrontations in the South China Sea or the Taiwan Strait
- **EM political instability driven by** higher food and energy prices, leading to a wave of unrest
- Iran or Korea **nuclear programs** renewed concerns and sanctions
- **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

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

- Credit & equity, EMBI

CROSS ASSET DISPATCH: Detecting markets turning points

The turning point has occurred | Approaching the turning point | Not reached yet too early to call it

ECONOMIC BACKDROP

- Economic momentum is slowing progressively amidst persistently higher inflationary pressures and weakening domestic demand. While we still expect a soft landing for the US, recession risks are rising for mid-2023. On the European front, we expect a cost-of-living and inflation-driven recession during winter.
- Directions of revisions on inflation and growth outlooks keep diverging amidst a stagflationary momentum.
- The prolonged stress on commodities and energy prices, leading to more persistent inflation and tighter monetary policies, is exacerbating economic uncertainty and data volatility.

FUNDAMENTALS & VALUATION

- The liquidity-driven rally we got during the summer has cleaned up the undervaluation we had in most risky assets.
- Stock multiples seem still too complacent, given central banks' intentions (which suggest rates will stay high for longer) and the higher probability of recession still has to be translated into lower EPS expectations (consensus expectations are still too optimistic).
- Fundamentals are worsening with respect to last month as stagflation should sound an alert for corporates' profitability.

NEUTRAL + ASSET ALLOCATION

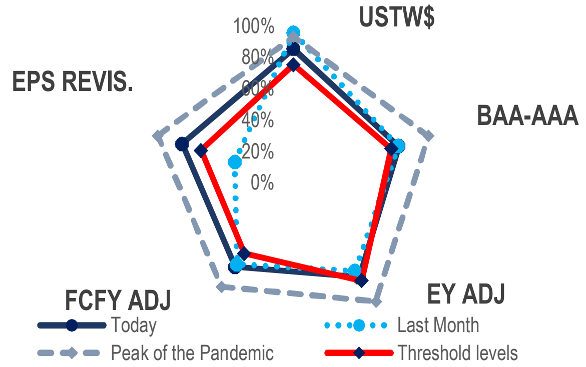
TECHNICALS

- Technicals remain the only dimension able from time to time to call for a risk increase in the portfolio. Whilst the summer rally has cleaned up most contrarian signals (fear & greed, bull/bear and positioning all turned less favorable moving towards Jackson Hole), we are not seeing fragmented trends, as we had in past episodes of markets correction. Positioning, though, may be less clean than surveys suggest. Institutional investors still seem to have positions in risky assets, and additional negatives (macro, micro) may induce further de-risking from current levels.

SENTIMENT

- Financial conditions eased during summer and explain most of the rebound in risky assets we have seen.
- Risk concentration in the market, though, remains elevated and overall risk-off probability continues to suggest a defensive allocation in the short-term.
- The deterioration in risk sentiment metrics has started affecting fundamentals. EPS revisions have turned negative, the USD is staying strong, and Moody's Baa-Aaa remains above alert (despite the recent tightening).

Cross Asset Sentinels Thresholds (CAST) still supportive



Source: Amundi Institute, Data as of 26 August 2022

The CAST risk perception failed to show a structural increase in Q1, but has turned less favourable since Q2. EPS revisions have turned negative in response to recession fears, and the USD remains the dimension calling loudly for risk-off. Credit risk premium remains high and above alert, all in all calling for a defensive stance across risky assets.

Methodology: We consider five inputs, which we call "sentinels": USTW$, Moody's Baa-Aaa, EPS revisions, Adjusted Earnings Yield Risk and Adjusted Cash Flow Yield Risk. These sentinels are used to reposition our tactical asset allocation. Once sound thresholds are detected, the five variables are aggregated as an indicator that anticipates the market's stress conditions, with a certain level of conviction. The pentagon visualises the five sentinels, where the red line represents the alert threshold. The greater the distance above the red line, the greater the risk perception, and eventually the need to move closer to a defensive asset allocation.

GLOBAL RESEARCH CLIPS

1 US macro forecasts revision: ongoing growth deceleration

- Growth deceleration is not yet due to the Fed's tightening policy. Yet a soft landing is possible and the risk of a full-blown recession in mid-2023 is non-negligible.
- US growth forecasts lowered on weaker consumption and investment (2022 GDP growth to 1.6% from 2.2%, and 2023 GDP to 1.0% from 1.5%).
- The labour market remains strong, but cracks are surfacing.
- High inflation is here to stay, notwithstanding loosening bottlenecks and easing pricing pressures.
- The Fed remains committed to hiking rates, by 75bp in September, followed by three consecutive 25bp hikes, leading to a terminal rate of 4.0% by February 2023.

Investment consequences

- Maintain an underweight on global equities due to further deterioration of the economic backdrop in 2022-23.
- Tilt towards high-quality credit and inflation-sensitive asset classes such as inflation-linked and commodities.
- Long USD vs. most G10 FX, potential for the EUR/USD cross exchange rate to move to 0.94 in the short term.

2 Europe: recession led by cost of living crisis is expected in 4Q22 / 1Q23

- Inflation in Europe is expected to peak over the forthcoming winter season to near double digits (due in part to Russia's weaponisation of gas).
- Eurozone countries will suffer a direct impact from gas supply, inflation and second-round effects from Germany's recession.
- The stagflationary shock will be extended, amid limited fiscal room, weaker global growth, and globally tighter financial conditions, leading to a recession in autumn-winter.
- We now expect the Eurozone's real GDP growth at 2.9% in 2022 and 0.3% in 2023.
- Germany and Italy are expected to be hit the most, with France suffering relatively less. Spain is the least exposed but still not immune.

Investment consequences

- The ECB's terminal rate is seen at 1.00-1.25% by year-end thanks to two consecutive 50bp hikes (September and October 2022), followed by one 25bp hike in Dec 2022.
- We remain cautious on peripheral debt and euro credit, as current valuations do not price in a long-lasting deterioration in the Eurozone energy sector.

3 Q2 earnings season update: strong Q2 EPS supports countertrend rally, but results are of 'low quality'

- Q2 EPS came even stronger than the market's high expectations, but margins are narrowing.
- EU results are largely driven by the energy sector, inflation, and currency weakness.
- US Q2 EPS YoY growth is expected to turn negative, excluding the energy sector.

Investment consequences

- Resilient earnings are not a sufficient reason to turn more bullish on equities at this stage. We are maintaining a cautious stance on equities.
- We favour US equities over the Eurozone.

4 Private equity and real estate: illiquidity risk premium should help

- Real estate prices are vulnerable to higher interest rates. However, this is unlikely to lead to a 2008-09-style meltdown.
- Monetary policy tightening and nominal GDP deceleration will drain liquidity in 2023, paving the way for de-risking and a focus on illiquid defensive assets such as private debt.
- The illiquidity risk premium has historically paid off in this environment.

Investment consequences

- The liquidity drain expected in 2023 should favour illiquid and defensive assets, such as private debt, replacing HY credit allocations.

GLOBAL RESEARCH CLIPS

5 China: factor in a greater housing slowdown

Recovery still the central case and a recession is not in sight:

- The economy recovered further in July and August, albeit with momentum slowing notably from the jump in June.
- Domestic demand indicators were sluggish across the board, reflecting an overall lack of confidence in the private sector.
- The housing downturn, complicated by sporadic Covid-19 restrictions, is weighing on China's economic recovery, dampening fiscal and monetary easing efforts.

Housing: too late and too reserved

- Housing sales have remained on a sharp downtrend and the central government has stepped up its support
- Yet measures to boost demand have already entered an ultra-loose era (governments already relaxed purchase restrictions months ago and mortgage rates are at multi-year lows).
- We expect a bigger housing contraction from August to December, at -20% YoY vs -8% YoY expected in July.

We are downgrading our 2022 annual growth target to 2.9% from 3.2% and to 5.2% from 5.5% for 2023

Investment consequences

- Maintain long MSCI China, HSCEI and HIS.
- Neutral on Credit and long on China.

Covid-19 situation update

Francesca PANELLI, *Investment Insights and Client Division*

The Covid-19 wave driven by the BA5 variant of the Omicron family that hit Europe and the United States in June and the first half of July, started to ebb in late July and August, despite the peak tourism season, while the number of fatalities and hospitalisations stayed limited. According to the European Centre for Disease Control, during the week ending on 31 July, overall 14-day case notifications remained high in the EU (842.5 cases per 100,000 people), but transmission had been falling. The epidemiological situation is still uneven across the EU, with the situation still worsening in Eastern Europe, where vaccination coverage is lower. Uncertainty remains high on the upcoming fall-winter season and a possible new wave. At the same time, it is uncertain whether updated vaccines against the BA4 and BA5 variants will be available later this year, as clinical trials have proved difficult due to the high exposure of population to the virus, due either to vaccination or having caught the virus.

In the United States, the situation is similar, with the Centre for Disease Control loosening its recommendations, which from now on will be focusing only on how to protect highly vulnerable people. At the same time, Covid-19 cases jumped to a three-month high in China, mostly in the touristic Hainan island, which is locked down almost completely at the time of this writing. New outbreaks are also flaring around the country, including in Shanghai, possibly leading to renewed lockdowns. As such, Covid-19 will remain an important factor influencing economic activity over the next few months.

AMUNDI ASSET CLASS VIEWS

Platform	Asset Class	View	1M change	Rationale
EQUITY PLATFORM	US	=/+		Overall consumption is strong but there are early signs of weakness. In this environment, earnings growth (this year and 2023) should drive markets. Thus, we remain vigilant of any indication of falling demand, and, in the process are exploring names with strong earnings potential and a track record of rewarding shareholders.
	US value	+		While value has outperformed this year, this has not been linear as concerns over growth have emerged. We think investors should complement value with quality and less cyclical names that can better withstand earnings pressure and offer attractive valuations. On the other hand, we do not like distressed, expensive value stocks and remain selective.
	US growth	-		As the Fed looks committed to hiking rates to tame inflation, we think this could put further pressure on growth stocks, especially the expensive and unprofitable ones. Some quality growth names are displaying reasonable valuations, but our focus continues to be on earnings potential.
	Europe	--	▼	A recession in the region is likely to be caused by high inflation, which is increasing the cost of living and will eventually affect consumer demand. We see near-term risks on earnings and are becoming slightly more conservative. But we maintain a focus on stock selection, balance sheet strength and companies with the ability to deliver sustainable profits.
	Japan	=		Slowing global growth could present headwinds to the export-driven Japanese markets, but relatively attractive valuations and a weakening yen are positive.
	China	=/+	▼	Supportive policy, the economic reopening and the move towards a more balanced growth model are all positive. However, sporadic Covid lockdowns and the weakness in the housing sector are likely to weigh on economic growth in the near term.
	Emerging markets	=		Even as divergences continue to prevail in EM, the DM-EM growth differential is evolving in favour of the latter. This underscores the need to be selective and mindful of geopolitical risks and of the commodities/inflation impact on domestic demand. We like Brazil and the UAE (commodity exporters) but are cautious on Thailand.
FIXED INCOME PLATFORM	US govies	=		Yields are oscillating in opposite directions, led by market expectations of inflation, economic growth and the Fed's policy response. While a 'soft landing' in the US seems possible, inflation is still high and accordingly the Fed remains hawkish. Hence, we stay neutral but are very active. We are also evaluating the TIPS market after the recent increase in real yields.
	US IG corporate	=/+		The asset class provides attractive carry, displays strong corporate fundamentals and should benefit from the resilience of the US economy. However, there is limited visibility on earnings owing to some pressures on consumer demand. In addition, valuations are close to their long-term averages, and thus we remain selective.
	US HY corporate	=		In an environment of subdued growth, we believe investors should watch out for the default outlook and how earnings weakness could affect cash flow generation capabilities and fundamentals, which remain solid for now. We focus on liquidity in light of the tightening Fed and persisting inflation.
	European govies	=		The ECB is committed to controlling inflation and is likely to raise rates higher than previously expected. However, it has to balance this with the need to prevent fragmentation. We are neutral on core Europe but flexible across curves. Even in peripheral debt, we are neutral amid the potential pressures from political events despite the ECB's support.
	Euro IG corporate	=		The near-term recession outlook, high inflation and a hawkish ECB mean potential pressures on earnings and spreads. Thus, while we prioritise quality in our portfolios, we are monitoring decompression risks and whether fundamentals will deteriorate owing to pressures on consumer demand.
	Euro HY corporate	=		We are vigilant in EU HY and are monitoring the default outlook, which is robust for now. But if financial conditions tighten and markets come under stress, liquidity could dry up, especially in overleveraged areas, on which we are cautious.
	China govies	=/+		China continues to offer diversification benefit and the downgrade of the country's growth, along with an accommodative stance, should be positive for bonds. However, we are monitoring the evolution of the real estate sector.
	EM bonds HC	=/+		With a preference for HY (despite the recent inflows-driven rally) over IG, we believe HC offers attractive opportunities but we remain selective. In the near term, some primary market issues could be available at a discount.
	EM bonds LC	=		We are prudent and highly selective in light of inflation and prefer high carry trades (i.e., South Africa and Brazil). EM FX could come under pressure in the short term as the dollar shows strength, and thus we favour relative value trades.
OTHER	Commodities			Decelerating global growth and Chinese demand could cap oil prices and other cyclical commodities. However, downside risks appear limited given the persistent supply issues and geopolitical uncertainty. Our 3M target for WTI is $100/bbl. Gold fundamentals are a bit complicated. A tightening Fed and rising real rates are not supportive in the near term.
	Currencies			The USD is likely to benefit from rising rates in the US and pressures on global growth. Our 6M target for EUR/USD is 1.0 and the regional currency may even fall below parity in the near term. However, if the Fed turns dovish (not our central case in the medium term), that would put pressure on the greenback.

LEGEND

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Negative Neutral Positive Downgrade vs previous month Upgraded vs previous month

Source: Amundi, as of 2 September 2022, views relative to a EUR-based investor. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research, investment advice or a recommendation regarding any fund or any security in particular. This information is strictly for illustrative and educational purposes and is subject to change. This information does not represent the actual current, past or future asset allocation or portfolio of any Amundi product. IG = investment grade corporate bonds, HY = high yield corporate, EM bonds HC/LC = EM bonds hard currency/local currency, WTI = West Texas Intermediate, QE = quantitative easing.

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