THEMATIC GLOBAL VIEWS

Pierre BLANCHET,
Head of Investment Intelligence

Didier BOROWSKI,
Head of Global Views

Tristan PERRIER,
Global Views

You asked, we answer

Our Global Views team attempts to answer some of the questions often asked by our clients.

What are the key political events in the EU in 2022?

A number of scheduled country-level elections will carry moderate uncertainty. However, while they could bring new faces, they are unlikely to result in abrupt changes from the current generally pro-European and market-friendly stance of large EU countries' governments..

Key developments on this front have already happened in 2021, first and foremost through:

1. **The formation of the cabinet of Mario Draghi (an ex-ECB chief)** in February in Italy, seen as instrumental in retaining the trust of both the markets and Northern European countries that Italy will make good use of the European NGEU Recovery Fund and deliver the expected reforms.
2. **The German general election, in September,** which yielded a tripartite government (Social Democrats + Greens + the pro free-market FDP) seen, at the very margin, as more conducive to further European integration than the previous (Merkel) government.

H1 2022 will also see notable political events in Italy and France.

The Italian presidential election (through parliamentary votes) scheduled for January may cause some noise, yet probably no radical change. It is unclear at this stage whether a majority can be reached through a pre-agreement among political parties, to smoothly approve a successor to current President Sergio Mattarella. While Draghi himself could probably secure the necessary votes to become the next president (indeed, he recently hinted that he would accept the position), his change of role from prime minister would require the formation of a new government, with the risk that it could be weak and possibly lead to snap general elections before the scheduled June 2023 ballot. However, most Italian political forces will probably favour continuity in a period that is critical for the recovery and for the way the country is viewed in Europe, with the most probable scenarios being: 1/ Draghi becomes president while agreeing with most parties on a successor prime minister to continue to steer the country in the same direction. 2/ parties finally agree on a new president (or the re-election of Mattarella, should he drop his current rejection of another term of office), leaving Draghi in his current role. Both these scenarios would be regarded as positive from a market/ European policies perspective.

The French electoral cycle (presidential elections on April 10 and 24, and legislative elections on June 12 and 19) is also unlikely to lead to any radical change. By far the two most likely outcomes are a re-election of Emmanuel Macron or his defeat by mainstream right-winger Valérie Pécresse, with, in both cases, the legislative election yielding a centre-right or moderate-right majority or coalition. While the details of Macron's and Pécresse's policies may have different effects on the French economy over the long term, both will be seen (just slightly more in the case of Macron) as strongly committed to the European project. Some moderate market stress is possible during the election process, as far-right parties are strong in polls and one of them could possibly make it to the second round of the presidential ballot, whereas left-wing parties are very weak and divided. However, it is very unlikely that either of the far-right parties could win the second turn. Moreover, the far right has removed Frexit from its agenda, meaning that the risk it carries from a market perspective is less than in 2017.

Another event to watch will be the snap general election in Portugal, on January 30. This election was called after the budget proposed by the Socialist minority government was rejected by Parliament in October, which has made it more difficult, among other things, to use the NGEU funds. The latest polls show Prime Minister António Costa's Socialist Party in first position, although short of a majority, and a strong showing by the far right (until recently, not a major political force in the country). However, given the country's strong track record in terms of implementing EU-recommended reforms (that were not reversed despite the Socialist party's parliamentary alliance with the far-left), and the generally pro-European stance of most parties, this election is unlikely to generate a lot of market stress.

In the non-Euro EU, the Hungarian general election (with the date to be confirmed in April or May) may bring significant change, as Prime Minister Viktor Orbán, whose policies have often conflicted with those of the EU majority, is currently meeting a strong challenge in polls from the pro-European United Opposition, led by moderate right-winger Péter Márki-Zay.

Will the European Capital Market Union (CMU) make progress in 2022?

In 1H 2021, capital markets increased the supply of financing to companies. EU ESG debt markets grew rapidly. However, the equity gap remains and securitisation markets have declined. Capital markets remain too fragmented in Europe. The good news is that the CMU is moving forward. On 25 November, the European Commission announced a package of measures to improve

THEMATIC GLOBAL VIEWS

the ability of companies to raise capital across the EU. In practice, these measures will ensure that investors have better access to company/trading data, encourage long-term investment, facilitate the cross-border sale of funds, improve the connection between EU companies and investors, improve companies' access to funding, and broaden investment opportunities for investors. **A deepening of the CMU is therefore in sight for 2022.** In line with the September 2020 Action Plan, the Commission announced that it will follow up in 2022 with more CMU actions, including an initiative on corporate insolvency.

This is a sweet spot for the EU: the combination of a new political/institutional environment, the implementation of the NGEU, the revision of fiscal rules (see our text in October Cross Asset), and the deepening of the CMU will allow for greater flexibility in the policy mix, facilitate real convergence, and deepen financial integration. This should foster resilience of the Eurozone and improve the allocation of savings.

The political situation in Europe this year is unique. For the first time since the birth of the euro, the leaders of the three largest Eurozone countries are very familiar with European institutional issues (CMU, BU, and fiscal rules). With France taking over the rotating presidency of the European Union in the first half of the year, Macron has a unique window of opportunity to further push the European agenda.

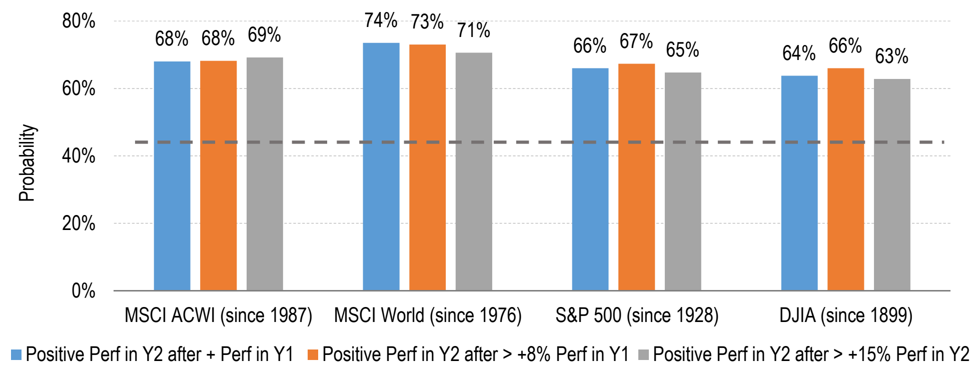
If he succeeds, the NGEU would have a better chance of turning into a permanent instrument in the coming years and facilitate the green and digital transformation. Moreover, it is good for foreign-investor sentiment and should thus contribute to attracting capital flows to Europe.

Are the equity markets more likely to fall in 2022 after their strong performances of 2021?

2021 brought strong performances of equity indices, and many investors are concerned about markets levels and the risk of a sharp correction in 2022. However, is it true that when equity markets have had a good year, they fall during the following year? The short answer is no. If you look at yearly returns of major equity indices (MSCI World, MSCI AC World, S&P 500 or Dow Jones Industrials) since they have been published, the probability of a second year of positive performance is close to 70% on average, with a very narrow dispersion of those probabilities among indices. Adding the condition that year 1 performance was above 8% brings the probability slightly down to around 66%, and it is greater than 60% for all indices when the previous year return was above 15%[1]. Therefore, the fear that equity markets are more likely to go down when they have had a good year is statistically unfounded. Actually, there is a much higher chance that the positive momentum will continue. That is the *power of momentum.* It does not mean that equities will with certainty finish 2022 in positive territory, but merely that 2021's strong performance is not *per se* a reason to be bearish. There are many other reasons why equity markets could go down in 2022, including the Covid risk, valuations and central banks hawkishness. Amundi is neutral on the asset class at the start of the year. But if equities do fall, it won't be only because they went up last year...

[1] *For example: Since 1987, the MSCI World index has 'turned positive' 34 years (out of 46). In 25 years, it turned positive after turning positive the previous year. So, the probability of turning positive after a positive year for this specific historical sample is 73.5% (25/34). The index had a >+8% performance in 26 years (out of 46). In 19 years, it turned positive after having a >+8% performance the previous year. So, the probability of turning positive after a year with this performance for this specific historical sample is 73% (19/26)*

1/ Probability of a positive performance in Year 2 after a positive performance in Year 1



Source: Amundi Research - Data as of 15 December 2021

Why are real interest rates so negative and why is that an issue?

Real interest rates are usually defined as the difference between interest rates (for instance, yields on 10-year bonds) and annualised inflation. This relationship, known as the Fisher equation, shows the purchasing power of this year's bond coupon. In theory, the bond market

THEMATIC GLOBAL VIEWS

is discounting actual and future growth and inflation. Therefore, real interest rates reflect growth prospects and time preferences.

At the time of this writing, the US real rate for 10 year Treasuries was -5.4% and -5.3% for the real rate on 10-year German Bunds. These numbers suggest that growth would be negative over the course of the next 10 years. They could also highlight that investors do not believe inflation is sustainable. Using inflation forwards[2], we can adjust for that, and in the case of US 10 year Treasuries, we find -1% and -2.2% for Bunds. The Cleveland Fed publishes a UST 10y real interest series using a more complex model that includes inflation data, inflation swaps, and survey-based measures of inflation expectation (which estimates the rate of inflation over the next 30 years). It has found that today real interest rates are negative. In recent history, this has only happened after the Global Financial Crisis and during the Fed QE infinity (QE3's nickname because of its open-ended nature) and the Eurozone crisis. Longer market history shows that real interest rates were also negative around the two oil shocks, i.e., when inflation was rising very sharply, and in the early 1950s, while the Fed was controlling interest rates. Today's real interest rates levels are similar to the 1970s oil shock.

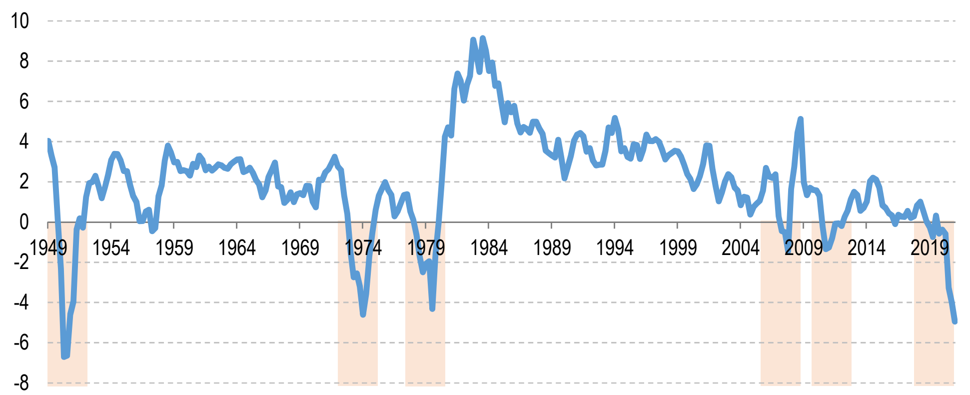
There could be two main reasons why real interest rates are negative: either because inflation is rising a lot faster than market expectations or because the central bank (the Fed in our example) is capping interest rates or at least containing interest rates adjustment via QE, or a combination of both. Investor flows into government bonds for safety or regulatory reasons are dragging down interest rates, too. It is worth noting that phases of negative real rates only last a few years and tend to rise sharply into positive territory afterwards.

Negative real interest rates hurt pension savings and push savers to invest into inflation-proof assets; they lower the cost of funding and support risky asset valuations, and long-duration assets such as high-growth stocks could create more systemic risks, such as asset price bubbles (in real estate or crypto) and eventually undermine the financial systems.

Real interest rates tend to revert back to zero in a sharp move as we have seen in 1975; 1980, 2008 and to a lesser extend in 2012. Given today's low levels, it will certainly increase the bond market volatility and could cause a temporary selloff in risky assets.

[2] *Market price of 5y5y inflation forwards in USD and EUR*

2/ US real interest rates since 1949 - (US 10y Treasury yield constant maturity minus CPI inflation)



Source: Refinitiv Datastream, Amundi Research, December 2021

What if Joe Biden's 'Build Back Better' fails to pass Congress?

Despite long negotiations, Joe Biden's flagship "Build Back Better" (BBB) policy is still short of a majority in Senate. Conservative Democrat Senator Joe Manchin is opposing the bill, which includes new social and climate change-related investments, and stopped the legislative process. Though it is not clear under which form the package will eventually come back, it is unlikely to stay in its current form and size ($1.75t). Therefore, the most likely scenario is a reduced package of $1.2 to $1.5t.

In our projections, we assumed only legislation that has already passed, i.e., the so called Bipartisan Infrastructure Plan, projecting 3.7% and 2.1% growth for 2022-2023, whilst projections for a BBB plan fully implemented would raise growth to 4.5% in 2022 and 2.6% in 2023.

A short-term impact is that several pandemic-related support packages, such as Child Tax Credit, will disappear at the end of 2022. Under current legislation, eligible families receive a payment of up to $300 per month for each child under the age of six. The end of the Child Tax Credit would mean a sharp reduction of fiscal transfers to low and middle-income households with a negative impact on consumption and core inflation. This might therefore ease the Fed's inflation expectations.

Finalised on 21 December 2021

Amundi ASSET MANAGEMENT | Research

CROSS ASSET INVESTMENT STRATEGY

January 2022 # 01

Amundi Research Center

Find out more about Amundi publications

research-center.amundi.com

Chief editor

BLANQUÉ Pascal, *Group Chief Investment Officer*

Editor

DEFEND Monica, *Global Head of Research*

Deputy-Editors

BLANCHET Pierre, *Head of Investment Intelligence*
BOROWSKI Didier, *Head of Global Views*

Global Research contributors

AINOUZ Valentine, *Deputy Head of Developed Markets Strategy Research, CFA*
BELLAÏCHE Mickael, *Fixed Income and Credit Research Strategist*
BERARDI Alessia, *Head of Emerging Macro and Strategy Research*
BERTONCINI Sergio, *Senior Fixed Income Research Strategist*
BLANCHET Pierre, *Head of Investment Intelligence*
BOROWSKI Didier, *Head of Global Views*
CESARINI Federico, *Head of DM FX, Cross Asset Research Strategist*
DROZDZIK Patryk, *Senior EM Macro Strategist*
GEORGES Delphine, *Senior Fixed Income Research Strategist*
HUANG Claire, *Senior EM Macro Strategist*
PERRIER Tristan, *Global Views*
PORTELLI Lorenzo, *Head of Cross Asset Research*
USARDI Annalisa, *Cross Asset Research Senior Macro Strategist*
VANIN Gregorio, *Cross Asset Research Analyst*
VARTANESYAN Sosi, *Senior Sovereign Analyst*

With the Amundi Insights Unit contribution

BERTINO Claudia, *Head of Amundi Investment Insights Unit*
CARULLA Pol, *Amundi Investment Insights Unit*
FIOROT Laura, *Deputy Head of Amundi Investment Insights Unit*
DHINGRA Ujjwal, *Amundi Investment Insights Unit*
PANELLI Francesca, *Amundi Investment Insights Unit*

Conception & production

BERGER Pia, *Research*
PONCET Benoit, *Research*