CENTRAL & ALTERNATIVE SCENARIOS (12 TO 18 MONTHS HORIZON)

Monthly update

We maintain the narrative and probabilities of our central and alternative scenarios. In our central scenario, equities outperform on the back of abundant liquidity, improving fundamentals and accommodative monetary policy. Vaccine-resistant virus variants, hawkish policy surprises and geopolitical tensions are the main sources of risks. Beyond 18 months, we expect (US) growth to revert to potential amid a higher inflation regime while stagflationary pressures rise across Europe. As risky assets valuations are stretch, we believe there are narrower margins for a policy mistake or adverse events.

DOWNSIDE SCENARIO 10%

Multifaceted pressures*

Analysis

- Genetic evolution of the virus leading to new global lockdown measures and growth relapses
- Vaccine side-effects and/or lasting shortages undermine confidence and diminish recovery prospects
- Highly pro-cyclical US policy ends up destabilising inflation expectations and causes a rise in interest rates, the USD and/or commodities; hurts risky assets (through a volatility shock) and impairs financial stability. Tighter financial conditions exacerbate economic and financial fragilities
- The Eurozone fails to engineer a recovery, with some over-indebted countries falling into stagflation
- Falling medium-term growth expectations undermine public debt sustainability
- Slowdown in Chinese growth is faster than expected and spills over into DM economies
- The rebalancing of geopolitical equilibria leads to protectionism and deglobalisation, negatively affecting trade and global value chains

Market implications

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

CENTRAL SCENARIO 70%

Multi-speed recovery

Analysis

- Vaccine rollouts lead to a strong but uneven and multi-speed recoveries across regions: stronger in US and Europe, weaker in EM
- US policy boosters narrow the growth premium gap between EMs and AEs
- Accommodative monetary and fiscal policies continue to support the recovery, keeping deflationary risks at bay and allowing debt/GDP ratios to stabilise for the time being
- Despite political commitment to mobilise fiscal policies, execution in the EU is diluted
- Solvency risk recedes, thanks to positive corporate earnings momentum, active deleveraging and low funding costs, especially for low-rated issuers and impacted sectors
- Income and wealth inequalities are exacerbated by the Covid crisis and increased social and political tensions
- Macro and micro fundamentals cause positive momentum to pause. Stretched risky asset valuations and technicals narrow the room for manoeuvre if something goes wrong

Market implications

- Equities remain the asset of choice in this phase of the cycle. Value and cyclicals outperformance to continue. Favour barbell positioning in the equity and currencies space
- Contained steepening of US Treasuries yield curve spills over into EZ and EM.
- Maintain growth and income pockets with EM equity and credit on rising earnings. Selective on EM HC.
- Favour linkers as an inflation hedge

UPSIDE SCENARIO 20%

Sustainable & inclusive recovery

Analysis

- Mass vaccinations resolve the public health crisis, enabling a full global recovery in 2H21
- With less uncertainty, policy boosters feed through to the real economy and financial markets, closing the gap between manufacturing and service sectors
- Savings turn into consumption on increased disposable income, which allows a virtuous circle of growth/inflation (no global overheating)
- Inclusive and sustainable growth diminishes the need for further policy support to reduce inequality gaps
- The US job market recovers faster than expected, and wage pressures arise but the Fed stays on hold
- Medium-term productivity gains from new digital and green developments

Market implications

- US Treasuries curves bear steepen on fast rising growth and inflation expectations
- Favour risky assets with cyclical and value exposure
- Favour linkers as an inflation hedge

* *There is no single downside scenario. Here, we take into account the many downside risk factors we have identified. These risk factors may or may not combine to give rise to a relapse in growth and/or higher inflationary pressures, and thus generate renewed volatility in the markets. Some risks are "exogenous" (e.g., pandemic dynamics and availability of vaccines), while others are directly related to the crisis and/or economic policies. While virus-related risks should decrease over time, thanks to the vaccination campaigns, the other risks mentioned in the Top Risks will have higher occurrence probabilities over the next 12 to 18 months.*

TOP RISKS

Monthly update

Risks are clustered to ease the detection of hedging strategies, but they are obviously linked. We have left the narrative and the risk of the central scenario unchanged this month.

ECONOMIC RISK 15%

- **Global tapering**
  - QE programmes may become problematic as inflation expectations rise
  - Inflation dynamics and central banks' reaction function could be sources of uncertainty, in particular in EMs, where inflation is close to most CBs' targets
- An early exit or miscommunication by the Federal Reserve could lead to a second taper tantrum, similar to 2013
- **Pandemic 2.0, with vaccine rollout issues**
  - One or several virus variants that would make existing vaccines ineffective and undermine the economic recovery
  - Unexpected logistic issues or side-effects of the vaccines could have a very negative impact on investor and business sentiment
- **A protracted recovery with multiple relapses** might hit business and consumer confidence, looping in sectors that have not yet been directly hit by the pandemic, such as financials
- **Underestimated hysteresis effects in the labour market,** with rising unemployment, could generate social tensions

+ **Cash, linkers, JPY, Gold, USD, Defensives vs. Cyclicals**

- **Oil, risky assets, AUD CAD or NZD, EM local CCY exporters**

FINANCIAL RISK 20%

- **De-anchoring inflation expectations** leading to a bond market dislocation as an outcome of policy mistakes (such as pre-emptive monetary policy tightening or outsized fiscal plans)
- **Corporate solvency risk:** Despite improving fundamentals, the magnitude of the recession could increase solvency risks once central bank liquidity and government guarantee schemes are withdrawn
- **Sovereign debt crisis**
  - With public debt as a share of GDP reaching historically high levels in peacetime, most countries are vulnerable to rating downgrades and rising interest rates, in the event of policy errors
  - Emerging market weaknesses (single-commodity exporters, tourism) could also face a balance-of-payments crisis and increased default risks
- **USD instability, which could impact in both directions:**
  - **(1) depreciation** could push the Fed to stop its APP and negatively impact the Treasuries market, bring deflation into the EZ and Japan, and undermine the EM recovery;
  - **(2) appreciation** could hurt EM countries, with higher UST yields spilling over into the Eurozone bond market

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

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

(GEO)POLITICAL RISK 15%

- **US/China cold war**
  - Democrats take a hard line with China
  - Several sanctions and delisting of Chinese companies are signs of escalation
  - Possible accidental confrontations in the South China Sea or the Taiwan Strait
- **Political instability within, and among, EM countries** on the back of chaotic virus crisis management and rising food prices
- **Post-Brexit risk of undermined European cohesion**
  - 2020 ended with an exit deal but implementation proves to be a lot more disruptive than expected
  - Tensions arise in Northern Ireland on new border rules
  - The City is losing market share faster than expected
- **Cyber-attack or data compromise,** disrupting IT systems (security, energy and health services)

+ **DM Govies, cash, gold, linkers, USD, volatility, quality**

- **Oil, risky assets, EMBI**

CROSS ASSET DISPATCH: Detecting markets turning points

How to the read turning point assessment

Not reached yet too early to call it | Approaching to the turnaround | Turnaround happened

ECONOMIC BACKDROP

- Economic activity is progressively accelerating in the euro area as the Covid-19 restrictions are eased. Soft data confirm the optimism underlying the ongoing reopening, delivering strong upside surprises. In particular, upticks in retail activity provide evidence of a progressive bottoming out of the sectors hardest hit, confirming the highlights of the latest PMI: the consensus shows signs of a moderate upward reversion, with France leading the way.
- Economic activity in the US is steadily gaining in momentum as confirmed by both soft and hard data. Surveys continue to surprise to the upside, mirroring the strong confidence underlying the reopening of the US economy. The consensus remains high, which should lead to a gradual reversal in economic surprises as further upside surprises become increasingly difficult to materialise.

FUNDAMENTALS & VALUATION

- Current credit and equity market levels are pricing a Goldilocks scenario, with a strong profit recovery and still dovish central banks.
- Absolute PE levels are above historical trends and is a sign a level of investor complacency.
- After the recent spike in long-term interest rates, the relative value metrics offer less support for equity markets to move significantly higher.

NEUTRAL + ASSET ALLOCATION

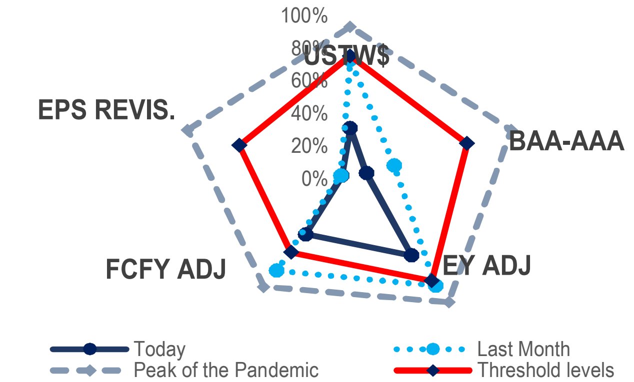
TECHNICALS

- Our technical metrics continue to depict a mixed environment for risky assets. Concerning last month, the material change relates to contrarian signals, which are in a far better position given the recent market sell-off.
- RSIs finally left the overbought territory in most market segments and could potentially attract investors.
- The seasonality factor, on the other hand, may have played a role and is translating into a far less clear-cut trend.
- As per last month, the technicals remain mixed and suggest a neutral stance on risky assets.

SENTIMENT

- Inflation scares led to a rise in volatility and consolidation in risky assets in May, as the pass-through to nominal and real interest rates was a headwind for the current high valuations. That said, our risk sentiment metrics continue to signal a benign market structure, with the recent USD sell-off and the improvement in the credit risk premium balancing the rise in volatility and the mild deterioration in financial conditions (Moody's spread below 70 bps for the first time since the beginning of 2019).
- A muted deterioration of sentiment combined with financial conditions in the top percentile of their historical distribution, could cause complacency in the market. Something to be closely monitored going forward.

Cross Asset Sentinels Thresholds (CAST) still supportive



Source: Amundi Research, Data as of 13 May 2021

CAST flags extremely low risk perception.

Sentinels remain in pro-risk territory due to a general improvement in all its components (except ERP adjusted for credit risk).

Methodology We consider five inputs which we call "Sentinels": USTW$, Moody's Baa-Aaa, EPS revisions, Earning Yield risk adjusted and Cash Flow yield risk adjusted. 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 visualizes the five sentinels where the red line represents the alert threshold. The greater the distance above the red line, the higher the risk perception, and eventually the need to move closer to a defensive asset allocation.

GLOBAL RESEARCH CLIPS

1 US inflation revised higher on a supportive mix of strong demand and robust pipeline price pressures

- While we confirm our 7.5% GDP growth mid-range projection for 2021, we have revised up the inflation pattern, now expected to hover above 3% till Q4 and then continue along a deceleration trend to end 2022 at 2.4%
- We expect US inflation to peak in Q2 on major base effects on the anniversary of the collapse of many prices during the first Covid-19 wave in 2020.
- Near-term inflation is expected to be particularly volatile on a monthly basis, from the interplay of stronger reopening demand on both goods and services, and constrained supply, in some cases exacerbated by production bottlenecks.
- The key risk to the outlook remains on the upside: a) greater pricing power on the reopening could lead to faster than expected pass-through of high input cost to output prices, which have so far materialised only partially; and b) a persistent rise in long-term consumer inflation expectations, could become more entrenched into the price setting process.

2 Potential DM equity markets consolidation as the economic momentum has reached its peak

- Several indicators are looking stretched: manufacturing PMI and ISM are at, or close to, historical highs, MSCI World and S&P 500 consensus forward EPS are already above pre-crisis levels, financial conditions are at their lowest percentile since 2007, and equity positioning are back to pre-pandemic levels.
- The great rotation out of defensives and into cyclicals is marking a pause. Valuations are stretched.
- We are downgrading Global Equities from overweight to neutral. However, we expect the market consolidation to be short-lived and that it wouldn't reverse the bull market.

3 LatAm's cyclical recovery runs into left swinging political pendulum

- The political pendulum in LatAm has clearly swung left, pushed by both pre-pandemic structural forces and, more recently, by a tough cyclical environment. Declining productivity and rising social demands compounded by the pandemic have caused a painful economic contraction.
- Public discontent and anti-establishment sentiment was already apparent in 2019.
- Chile's constitutional overhaul, now underway, rests in the hands of a fragmented and left-leaning body.
- In Peru, hard left presidential candidate Castillo is leading in the 2nd round polls with some radical ideas handy.
- Colombia's fiscal reform is detached from reality and is causing real economic and financial damage with the country's credit rating being downgraded to junk.
- Brazil's elections scheduled for late next year are giving the authorities more time to get the economy on a firmer footing and a chance to avoid a leftward shift with Lula.

4 Japanese growth downgraded on Q1 GDP miss and slow vaccination

- GDP came in much weaker than expected, with the slowdown in private consumption contributing more than half to the contraction.
- The share of population that has been vaccinated remains low (<10%), exposing Japan to a resurgence of infections. The state of emergency was expanded in early May, weighing on mobility.
- External demand remains as a bright spot, as overseas machinery orders skyrocketed.

AMUNDI ASSET CLASS VIEWS

	Asset Class	View	1M change	Rationale
EQUITY PLATFORM	US	=		The economic reopening and fiscal spending by the Biden administration should support overall growth and demand, but there are corners of extreme valuations in the market. In addition, supply shortages and potential tax hikes remain issues that could weigh on demand. As a result, we remain selective, are monitoring risks and play through rotations linked with a recovery favouring cyclical and value stocks.
EQUITY PLATFORM	US value	+		Decreasing restrictions on people's movements and the progress in vaccinations (in the US and outside it) continue to provide a boost to consumption demand and economic growth. As a result, we believe the rotation in favour of value will gain further momentum, especially as we see signs of some inflation. There are also opportunities to identify high-quality, stable companies with potential to be the ESG leaders of tomorrow.
EQUITY PLATFORM	US growth	-		Our cautious view on growth, particularly hyper-growth, remains amid the still-high valuations. As economic growth returns and interest rates rise in future, investors should explore better-priced areas less affected by rising discount rates.
EQUITY PLATFORM	Europe	=		The latest earnings season has been strong, indicating the importance of normalisation of economies. The region is still witnessing reopenings and that should support (non-linear) rotations in sectors linked with economic growth. However, we believe a lot of good news is already priced into markets. Therefore, we are monitoring inflation trends and focus on relative value and on companies with strong fundamentals and pricing power.
EQUITY PLATFORM	Japan	=	▼	A pause in global economic momentum could briefly affect Japanese markets. From a medium-term perspective, growth should be supported by exports, rising wages and the yen's weakening.
EQUITY PLATFORM	Emerging markets	=/+	▼	The prospect of rising US yields, along with idiosyncratic risks and external vulnerabilities, creates some near-term headwinds for EM. With a highly selective eye, investors should focus on value/cyclical areas linked with improving consumption, and sectors that show attractive valuations and sustainable trends.
FIXED INCOME PLATFORM	US govies	-	▼	We are seeing higher-than-expected CPI, supply shortages and the Fed prioritising employment. This, together with strong consumption, deficit concerns and government spending plans, indicates inflation will rise further, pressurising USTs. Investors should remain cautious and active in duration management but in doing so, they must avoid the mistake of going long duration. In contrast, Treasury Inflation-Protected Securities should do well as inflation moves upwards.
FIXED INCOME PLATFORM	US IG corporate	=		In light of upward pressure on core yields, we are limiting duration, interest rate risks and long duration debt in our portfolios. Instead, we focus on shorter maturity instruments and prefer idiosyncratic risks that allow more opportunities to stay selective. Amid improving consumer earnings, securitised credit seems attractive, particularly non-residential securitised debt. However, investors must be valuation-conscious.
FIXED INCOME PLATFORM	US HY corporate	=		HY carry is attractive and with the economy opening up, corporate fundamentals should improve. However, there is still a need to defend that excess income and balance the fine line between yield and quality through a selective approach.
FIXED INCOME PLATFORM	European govies	-/=		We believe improving economic growth (and potentially inflation) in Europe supports curve steepening, pressurising core-Euro bonds. Hence, we maintain our cautious stance. However, the ECB will prevent any significant increase in yields in order to support economic growth. On the other hand, we are constructive on peripheral debt.
FIXED INCOME PLATFORM	Euro IG corporate	=/+		We are constructive on IG in light of stable fundamentals and technicals, the massive liquidity in markets and the expectations of moderate improvement. Both ratings outlooks and free cash flows situations are also improving. But we remain selective, given the excess valuations in some cases and interest rate and duration risks. Overall, we like BBB-rated debt, shorter maturities and sectors (subordinated debt, energy, auto) linked with the economic recovery.
FIXED INCOME PLATFORM	Euro HY corporate	=		Corporate fundamentals are getting better on the back of an economic rebound, and this should be supportive of the default outlook. We prefer areas where there is scope for further spread compression, but we are very selective.
FIXED INCOME PLATFORM	EM bonds HC	=/+		We maintain our preference for HY over IG, in both the sovereign and corporate space, as HY is more fairly valued than it was at the start of the year. However, there are headwinds from rising US rates. From a long-term view, the asset class can be a good complement to investors' income generation strategy.
FIXED INCOME PLATFORM	EM bonds LC	=		The strengthening dollar and rising US rates are headwinds for LC debt and warrant a highly selective approach. We are particularly cautious on the rates side. On FX, we see some potential for a recovery in the second half of the year.
OTHER	Commodities			The global economic rebound is supporting commodity prices. Base metals such as copper witnessed a jump in prices due to rising demand (for green transitions and economic reopenings) and concerns over supply shortages. While the Fed maintains low rates for now, investors should keep an eye on rates movements and their effect on the price of gold.
OTHER	Currencies			'Twin deficits' in the US should weigh on the dollar in the long term. In the near term, the greenback should do well, particularly against low yielding FX (JPY, CHF) due to the economic growth differential. But the cyclical G10 FX block NOK, CAD and AUD is likely to perform well as economies open up.

LEGEND

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	Negative		Neutral		Positive		Downgrade vs previous month	Upgraded vs previous month

Source: Amundi, as of 22 May 2021, 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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