Research

#10
October
2021

CROSS ASSET
Investment Strategy

CIO VIEWS

Mounting risks, buying time

THIS MONTH'S TOPIC

Covid headwinds ease as China risks rise

Confidence must be earned
Amundi
ASSET MANAGEMENT

#10 - October 2021

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CIO VIEWS

Mounting risks, buying time

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Recently, financial markets have had to digest some mixed signals from the US economy (August jobs report and retail sales, latest CPI). The Fed announced a potential tapering, but the overall approach will be gradual and the 'not enough growth' narrative will remain dominant. We see two mounting risks in the background. The first relates to China: the summer spread of the delta variant, the renewed regulatory wave, and the Evergrande saga. The deceleration in the Chinese cycle will trigger fiscal and monetary accommodation, as was witnessed in the PBoC's latest move to avoid a liquidity crunch. Second is inflation in energy and food. The topic of rising energy prices is becoming hot in Europe, where gas prices have soared to record-high levels. Similarly, food prices are soaring and the issue is particularly critical for EM.

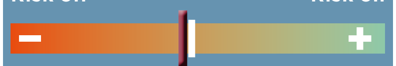
The two topics are important with regard to addressing the evolution of inflation narratives and with respect to long-term commitments of governments to addressing climate challenge. Against this backdrop, we need to reassess some key convictions and see if they might be valid moving into Q4.

- **Is it time to switch the risk allocation and become more defensive?** Given rising inflation risk and weakening economic momentum, stagflationary risk is on the rise. Yet, accommodative CBs and lack of alternatives to equities mean once again that it is difficult to see the market capitulating any time soon. Nevertheless, given the impressive performance YTD and the risks that inflation will further make the headlines, we recommend staying neutral in terms of risk allocation, with some hedges in place. We remain constructive on credit. With tight spreads, investors should look for places that could perform well with rising rates ahead and reopening of economies or with lower duration risk (subordinated, HY).
- **Is an equity value call still valid?** The value vs growth preference has been a key call since the start of the reflation trade initiated by vaccine rollouts. Fears of delta variant outbreaks had somewhat led to a pause in this trend over the summer. Yet, we believe there is room for this trend to develop further in both the US and in Europe, where the growth vs value valuation gap is still wide on an historical basis. The more we advance with the value call, the more some specific themes start to emerge. In the US, the value space is comprised of interesting business cases related to innovation around renewable energy that could see a further boost from the economic policies under discussion by the Biden administration. In Europe, financials and industrials offer interesting quality stocks. Here, it will be key to assess the impact of rising energy prices on margins on a case-by-case basis.
- **With looming tapering in the US and possible sticky inflation, what should investors do with their bond allocation**? Fixed income (FI) might seem to be a dead asset class, but it's not: it is being restructured in a way. It remains a key core component of investor portfolios, both for diversification purposes vs equity and for income needs. The short duration stance remains the key call. Investors should move away from a static benchmark approach (high duration risk) and embrace a more flexible allocation in the search for income. Pockets of value are available across the board in securitised markets in the US, peripheral in Europe, and selective EM bonds. Approaching the tapering period, investors should ensure that their core FI allocation is resilient to a more challenging environment.
- **Are EM broken or do they still present opportunities for investors?** So far in 2021, EM equity has significantly underperformed DM. A great chunk of this underperformance relates to China. The other reason has been the diverging path taken by economic activity amid slower vaccination campaigns in EM. While headwinds remain, with China investor sentiment still very weak in the short term, some political issues in LatAm and Turkey, and the Covid situation in Asia not yet normalised, the outlook is improving. Recently, economic momentum has started to improve in EM, with the economic surprise in EM outpacing that in DM starting from June. Allocation to EM could increase from a generally underweight position, but the move might accelerate only in the latter part of the year, when China regulatory issues could soften and the Covid situation in EM could become clearer. On EM bonds, the outlook is already more constructive, especially in HC credit and HY. With low yields across the board and a very gradual Fed approach to tapering, this space is attractive for investors' search for income.

Moving into Q4, we see three main themes that investors should monitor: the evolution of the stagflationary narrative; developments on the green front following the COP26 meeting; and the regulatory wave in China. Overall, with the strong risk assets performance YTD and looming risks, it seems better to remain cautious: don't chase the bulls but seek opportunities to rotate allocation towards less tight areas.

Overall risk sentiment

Risk off Risk on



Close to neutral/cautious stance on risk assets amid growth slowdown from peak levels and Central Banks' less-dovish tone.

Changes vs. previous month

- Near term caution on Chinese equities
- Tactical adjustment in core-Europe duration, periphery
- More watchful of asymmetric risks in US credit

Overall risk sentiment is a qualitative view of the overall risk assessment of the most recent global investment committee.

CB= Central Banks HC = Hard Currency, FI= Fixed Income, EM = Emerging Markets, DM = Developed Markets, YTD= Year to Date, HY= High Yield,

CROSS ASSET RESEARCH ANALYSIS

Central Banks at crossroads

Monica DEFEND,
Global Head of Research

The essentials:

- **Major central banks in western economies are tilting towards tightening.**
- **This is not a unanimous call: there is more asynchrony ahead, with a focus on tempering down the growth/inflation trade-off.**
- **On the latter, the path remains uncertain and we expect the 'not enough growth' narrative to remain dominant.**

Investors should look at labour markets, consumption expenditure and inflation data before deciding on asset allocation at a time when CBs are balancing peaking economic growth with rising prices

September has been a big month for CB meetings. The Norwegian regulator was the first major western central bank to increase rates after the pandemic emergency. The Norges Bank lifted rates by 0.25% on economic recovery and rising financial imbalances. Both the Fed and the BoE were more hawkish than expected, hinting at changes and spurring a global sell-off in the bond market. Equity markets, however, proved quite resilient, likely waiting for the next corporate earning season in order to test growth consistency.

The Fed signalled a faster taper than anticipated, to start in November, at a pace of $15bn per month ($10bn in treasuries and $5bn in MBS), potentially completing the pandemic-related bond buying by June 2022. The Fed's dots drifted higher, showing increased confidence with regard to raising rates around end-2022/the beginning of 2023, with a pace of three to four hikes per year. **Inflation will be the determining factor relating to rates hikes**. If core inflation surprises to the upside of the projected 2.3% for 2022, the first rate hike could be at end-2022.

The BoE's MPC meeting voted 7-2 to maintain the full schedule of QE purchases to be made by year-end, confirming the current QE stimulus in place. But, at the same time, the minutes surprised the markets and consensus to the hawkish side on forward guidance for rates, hinting at an earlier tightening. Developments in the labour market, in light of the concluding policy support schemes, will be key in calibrating the timing of rate hikes.

The ECB's move ahead is more cautious, recalibrating the flexible emergency programme first (PEPP current envelope is €1,850bn). We expect the ECB to buy an average of €70bn per month between September and end-March 2022. For the ECB, the conundrum will be explicit by then, as it will have to maintain a stable cost of financing of public debt as long as economic fragmentation prevails in the Eurozone. In fact, fiscal policy can only be effective if sovereign yields remain low and stable even in the face of growing deficits. In the absence of a significant increase in growth expectations, the ECB stands alone in trying to avoid financial fragmentation. The December meeting will be important in providing clarity on forward guidance.

All this comes at a time of trade-off between inflation (more persistent than expected, driving market participants' expectations higher) and economic growth (normalising after the post pandemic restart, but with risks from the virus variants, supply chain bottlenecks, and subtle fragilities hinted at by governmental support).

The tilt towards tightening, though, is not unanimous: we expect more inconsistency in the pipeline. The BoJ left policies unchanged, as expected, at its September meeting, noting that exports and production have been affected by supply-side constraints. We expect the BoJ to remain on put: it is too early to start the discussion on policy normalisation, since Japan's economic recovery has been slower than that of other DMs and inflation remains negative. The latter is projected to rise gradually in the medium term, but is still a long way off reaching the 2% target.

"First in / first out" applies to China, which is now facing another inflection point. The view that "2021 growth can print above 8% anyway" explains why Beijing is not backing off from regulatory tightening, notwithstanding the one-off overnight liquidity injections to preserve financial stability in light of the Evergrande saga. Growth figures have broadly surprised on the downside in Q3, with exports the only exception. Policy tightening, self-imposed restraints (zero tolerance Covid-19 policy, de-carbonisation production cut/electricity rationing), and global chip shortages all contributed to the slowdown. While the long-term outlook remains solid, we see more negative catalysts than positive ones on a six-month horizon. This would call for a prompt return to policy easing. The Chinese government has surprised over the years by its skill in negotiating crises, but we fear authorities might be late in delivering easing this time.

For investors, while labour markets, consumption expenditure, and inflation are the key sentinels to look at, the current asynchronies **open up opportunities in the fixed income and FX spaces**. On risk assets, we are not yet tempted to buy. While economic momentum softened during the summer, earnings expectations had been lowered only marginally. The reporting season in mid-October will shed some light on how much profit warnings have been discounted already. We will potentially recalibrate our risk stance by then.

MULTI-ASSET

Stay cautious, but don't be overly pessimistic

Matteo GERMANO,
Head of Multi-Asset

Amid abundant liquidity and CB support, we recommend investors stay neutral on equities and look for attractive entry points, but with sufficient hedges in place

We are witnessing a strong recovery with an uneven pattern and softening growth momentum. Upside inflation risks in Europe (energy prices) and the persistence of higher US consumer prices reinforce the case for a stagflationary environment. **Interestingly, this is balanced still easy financial conditions**. Thus, while acknowledging some risks related to valuations and potential pressures on corporate margins, we assert that this is not a time for any structural de-risking because there is no evidence of a profit recession. **Instead, investors should stay neutral and active on risk assets, looking for attractive entry points and maintaining hedges.**

High conviction ideas

We do not change our neutral stance on DM and EM equities but await better buying opportunities as valuations are well-above historical multiples, making the case for selection and vigilance even more relevant. In this environment, investors should prioritise relative value and must not lose sight of fundamentals. In EM, investors should evaluate Chinese equities in light of low visibility on the evolution of regulatory actions and how the Evergrande story evolves. Overall, for now, we prefer to stay on the sidelines till we gain more clarity on inflation, stimulus withdrawal, and the effects of virus variants on the economy.

We maintain our defensive stance on UST 10Y amid expectations of a steeper yield curve, with a marginally lower conviction now in upward rates movements due to the recent weaker-than-expected macroeconomic numbers, risks related to the spread of virus variants, and tapering. However, as far as current yields are concerned, we think they are low and inconsistent with the robust medium-term trends in economic growth and debt (infrastructure bills). In the UK, we maintain our yield curve steepener strategy. **The relative value offered by peripheral debt is attractive**, leading us to maintain our view on 30Y BTPs vs Bunds due to improving Italian growth prospects, the ECB's reaffirmed ultra-easy stance, and favourable technicals.

While we remain neutral on EM bonds, we believe they provide selective opportunities in our search for income. We keep our Chinese local government debt position. Near-term headwinds in the country, ongoing inflows, and the risk-off sentiment should be supportive, despite tight valuations and abundant debt supply.

Carry remains one of the main pillars of our view on credit as the economic backdrop and global reopening are supporting fundamentals and risk sentiment along with ECB purchases. But, we are monitoring the effects of rising core rates on IG markets. In addition, as we move lower into the capital structure to explore subordinated debt, we can access higher carry, but there is a need to balance quality and yield. On high yield, we stay positive amid downward trends in default rates, favourable financial conditions, and attractive carry. However, we are mindful of tight valuations and debt levels.

FX allows us to implement our views on countries and regions. We now believe near-term political headwinds, double-digit inflation, and fiscal challenges could affect the BRL/EUR. However, we maintain our positive view on the RUB, KRW (impetus from green policies) and CNH (support from intra-Asian regional trade) vs the EUR. In DM FX, we are constructive on the FX carry trade of the GBP vs the CHF and JPY. But, the GBP should be weak vs the EUR due to geopolitical fallout from Brexit.

Risks and hedging

We see a slight increase in risks linked to high valuations and a possible fourth wave of the virus resulting in renewed lockdowns. As a result, we maintain hedges to protect our DM equity exposure in the Japanese, US and European markets.

Amundi Cross Asset Convictions

	1 month change	---	--	-	0	+	++	+++
Equities					■			
Credit						■		
Duration				□				
Oil					■			
Gold					■			

Source: Amundi. The table represents a cross-asset assessment on a three- to six-month horizon based on views expressed at the most recent global investment committee. The outlook, changes in outlook and opinions on the asset class assessment reflect the expected direction (+/-) and the strength of the conviction (+/++/+++). This assessment is subject to change.
BoE = Bank of England, EM/GEM = emerging markets, FX = foreign exchange, FI = fixed income, IG = investment grade, HY = high yield, CBs = central banks, BTP = Italian government bonds, EMBI = EM Bonds Index.

FIXED INCOME

Look for carry and increase scrutiny on selection

Amaury D'ORSAY,
Head of Fixed Income

Yerlan SYZDYKOV,
Global Head of Emerging Markets

Kenneth J. TAUBES,
CIO of US Investment Management

The macroeconomic backdrop remains positive amid strong growth figures and easy financial conditions, but we are witnessing weakening momentum in the US and China. On the other hand, uncertainty remains elevated amid above CB-target inflation, the increase in the cost of shipping, distribution bottlenecks, and pressures to "de-globalise" supply chains. While we believe the Fed and the ECB may start tapering in the near future, we could see a surprise from the European authority. We could also see a debate on higher monetary accommodation if growth disappoints, next year, although this is not our base case. As a result, **we are cautious on duration, but believe it is a constructive environment to play inflation and credit with a selective approach** to identify 'rising stars' amid a better default environment.

Global and European fixed income

We are defensive on USTs and the debt of core and semi-core European countries, with the recent 'less dovish' stance of CBs reaffirming our view. While staying active on curves in the US and core Europe, we maintain a steepening view on the latter as we await the peak of growth. Euro-peripheral debt, such as that of Italy, is supported by a better economic outlook, but we prefer short maturities and think political risks must be monitored. Unsurprisingly, inflation is elevated in the US and Europe, even if there was some indication of a peak in the US. **We are constructive on credit (eg, in financials), but rely more on selection, exploring BBBs, which offer better risk/reward profiles vs A-rated debt.** In addition, we play the 'compression' theme by focusing on bottom-up analysis (improving credit metrics), short-/mid-term maturity debt, and ESG. This approach allows us to identify 'rising stars' HY names that possess the potential to move into IG. On the other hand, we avoid companies that could increase leverage or destroy value through M&A.

US fixed income

While consumer savings are elevated, uncertainty around the infrastructure bill and debt ceiling remains. In addition, continued disruptions in supply chains and potentially higher wage growth is putting upward pressures on inflation (cost-push). This, coupled with progress on labour markets, is causing the Fed to continue with its taper plans. Accordingly, we are cautious but active on USTs. TIPS offer attractive inflation-adjusted yields, but we are seeing excessive valuations. **On corporate credit, we are constructive and prefer short-term credit, recommending investors limit beta, especially in HY,** and focus on selection. Consumer credit and residential mortgage markets can deliver excess yield, provided investors remain valuation-conscious. Housing markets are showing strong fundamentals, but we are selective in CRE and remain vigilant amid Fed tapering discussions.

EM bonds

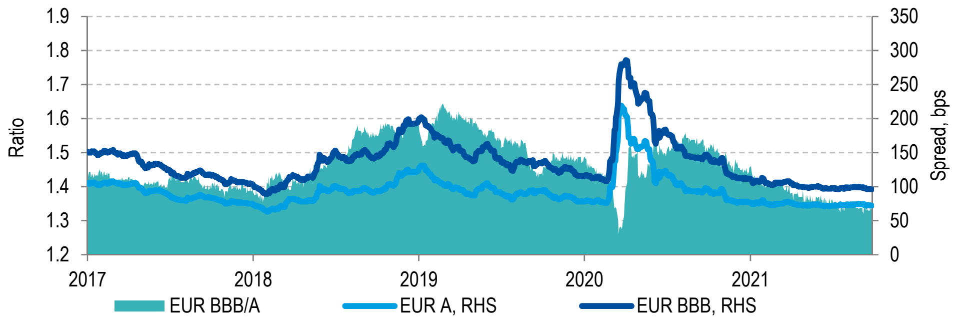
The EM-DM growth premium is expected to widen in favour of EM in Q4. This, coupled with an accommodative tone from DM CBs, is positive for the asset class. Our convictions remain on Hard Currencies and EM corporates (earnings recovery), with a bias towards HY vs IG and a bearish stance on duration across EMD. In local currencies, we remain cautious with a selective approach and are following the events in China. We focus on countries where EM tightening cycles are closer to ending, such as in Russia.

FX

In the short term, the USD should do well if growth disappoints and even when recovery is sound. We are positive on EM FX linked to commodities, but suggest investors be watchful of risks from a Chinese slowdown. Accordingly, we are positive on RUB and now on CLP, along with TRY and INR.

Default outlook in credit is benign but, with an eye on leverage, investors should avoid areas where risks are asymmetric and show a diminishing returns trend as we move across the quality spectrum

Striking a balance between quality and yield through BBBs



Source: Amundi, Bloomberg, as of 20 September 2021. Ratio of credit spreads.

GFI = global fixed income, GEMs/EM FX = global emerging markets foreign exchange, HY = high yield, IG = investment grade, EUR = euro, UST = US Treasuries, RMBS = residential mortgage-backed securities, ABS = asset-backed securities, HC = hard currency, LC = local currency, CRE = commercial real estate, CEE = Central and Eastern Europe, JBGs = Japanese government bonds, EZ = Eurozone, BoP = balance of payments.

EQUITY

Balanced stance, with a tilt to value, dividends

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Head of Equities

Yerlan SYZDYKOV,
Global Head of Emerging Markets

Kenneth J. TAUBES,
CIO of US Investment Management

Overall assessment

Markets were impacted by mixed global data and the spread of the delta variant, after reaching record highs in August. **However, as we pointed out in our previous edition, valuations were already high and the weakness in China and leverage concerns in the real estate sector seemed to act as a trigger.** Investors should note that while the recovery is strong, inflationary pressures are building globally. In Europe, surging energy prices should be seen from the prism of growing inequality, given that rising utility bills are politically unacceptable. Therefore, as we move towards low carbon-intensive technologies, the near- and long-term effects of the climate transition on inflation must be monitored. **We remain active, cautiously optimistic, and recommend investors follow earnings momentum without losing sight of fundamentals.**

European equities

We stay balanced and continue to believe in economic normalisation and reopening. We think there is still value in value in sectors such as banks, as implied expectations in these areas remain attractive. However, the **emphasis is more on bottom-up selection that could unveil companies possessing the potential to improve their ESG performances and reward shareholders through buybacks/dividends.** We also like industrials and financials sectors, but we are mindful of valuations across the board. At the other end, we like quality defensive names in the health care sector. However, IT and consumer discretionary are areas we are cautious about. Overall, investors should avoid distractions from short-term noise and focus on non-disrupted businesses that can deliver sustainable earnings.

US equities

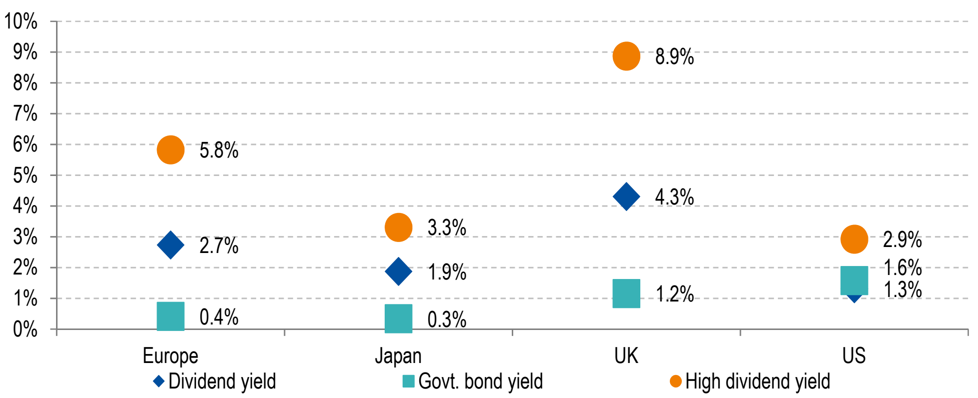
We believe there is uncertainty related to the timing and the amount of infrastructure plans and tax hikes. On the other hand, corporate margins and price pressures remain. However, economic reopening continues and real rates are still negative. Thus, while we are vigilant as the exceptional earnings performance this year will be difficult to repeat, we think this is not a time to be negative on equities. Instead, investors should look for company-specific factors and value names with a more domestic focus (such as banks) and less on cyclical value, as we highlighted earlier. In addition, we look for companies with a sustainable earnings potential and we focus on buybacks/ dividend opportunities. However, we are cautious on bond proxies and would avoid expensive growth and distressed value. At a sector level, we prefer financials, auto and aerospace, and energy companies sensitive to the climate transition. Within defensives, we like health care, due to the potential for innovation and R&D in the sector, but would keep an eye on valuations. On the other hand, we think consumer sectors are fully valued.

EM equities

Attractive valuations, improving earnings, and easing of headwinds from Fed tapering should be supportive. We are selective and prefer countries on their way to normalisation, thanks to vaccination programmes and development of natural immunity. In China, while we believe the authorities would avoid any contagion, uncertainty on regulation and slowdown induced us to tactically downgrade our view, favouring other countries, such as India, Russia or Greece. Long term, we remain positive amid the Common Prosperity theme.

Increasing energy, commodity prices are adding to inflation pressures, even as real rates remain low. In this environment, dividend-stocks could boost investors' overall returns

Dividends complement investors' income when rates are low



Source: Amundi, Bloomberg, as of 23 September 2021.

Upcoming 2022 Outlook

From European autonomy to strategic sovereignty

by Monica DEFEND, *Global Head of Research* - Pierre BLANCHET, *Head of Investment Intelligence*

The pandemic has highlighted Europe's dependency on several critical goods, including pharmaceutical products and medical equipment. The European Union found itself temporarily unable to ensure the security of the population because it has outsourced the production of these critical goods. Global supply-chain disruptions and the lack of manufacturing capacities in the region triggered a supply shock, with negative consequences for many industries, including the semiconductor and automotive sectors. Europe's vulnerability to external supply is now clear.

The European Commission has designed and begun to implement policies aimed at enhancing the Union's self-sufficiency in these critical areas and eventually reaching a form of European autonomy. Part of the Next Generation EU plan will be allocated to these sectors through the overarching Green framework. The initiative stands as an opportunity for private investors, as the investments required to meet the objective are significant and cannot be funded by public money alone. The amounts involved include more than €300bn for the semiconductor sector[1], more than €200bn in defence and security, and some €350bn for clean energy through 2030 in addition to the previous decade partly funded by credit and equity issuances. Moreover, Europeans now understand that they need to work together on electric cars and renewable energy, and on AI or cybersecurity. We believe that the full potential of the Single Market has not been fulfilled, particularly in services sectors, where substantial cooperation and growth remain untapped.

Against this backdrop, investors should not focus solely on the relative value of European assets and the ECB monetary policy. The key issue here is contributing to the renewal of economic sectors in proportions unmatched since the end of the Second World War. Europe's strategic autonomy is therefore an investment opportunity.

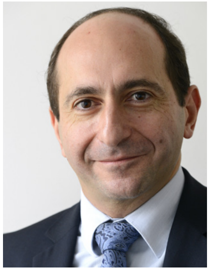
European autonomy does not necessarily mean protectionism. Rather, it corresponds to a new need emanating from a multipolar world in which the EU needs to define its position relative to the United States and China. Neither is strategic autonomy an end in itself. It is a step forward and a prerequisite for European sovereignty called for by many EU countries, including France[2]. A European army and digital independence are often referred to as missing pieces. The Common Market, the European Central Bank and Single Currency, and the Capital Markets Union are already instruments of sovereignty alongside the European Court of Justice[3]. But they need to be accompanied by a regional base of equity investors to ensure the strategic independence of European companies.

Sovereignty implies an alignment of interests between citizens and institutions, and between companies and their shareholders too. US investors own about one-third of the market capitalisation of the euro-area (2.3 times more than 20 years ago) and account for two-thirds of investment by non-residents[4]. Conversely, the share of European investors in the United States is relatively limited[4] and US pension funds are omnipresent in their own market, where they hold more than 68% of the market capitalisation. A full 37% of the financial wealth of American households is held in shares (mainly US stocks), compared with just 20% in France and 10% in Germany. This discrepancy can be attributed in part to the regulatory constraints weighing on the equity allocations of European institutional investors and the predominance of government funding. But it is not surprising that the governance of large European companies is sometimes not fully aligned with the priorities of the European Union. As such, European strategic sovereignty calls for renewed investment rules and stronger incentives to build a broader long-term European shareholder base and, potentially, a European sovereign fund. The good news is that European equities are cheaper than their US counterparts.

[1] *See "The price of self-sufficiency", Pierre Blanchet, Amundi Research, Cross Asset July 2021.*
[2] *President Macron's Sorbonne speech, 26 September 2017.*
[3] *"European sovereignty, strategy and independence", Chaillot Paper 169, July 2021.*
[4] *45% of the euro-area market capitalisation is owned by non-residents and less than 15% of US securities are held by non-residents. OECD Corporate Governance 2021.*

THEMATIC GLOBAL VIEWS

The Eurozone Gordian knot: how to reform the fiscal framework without abandoning fiscal discipline?



Didier BOROWSKI,
Head of Global Views

Reforming the European fiscal framework would improve the resilience of the Eurozone...provided that fiscal discipline is not abandoned.

The fiscal rules of the Stability and Growth Pact were temporarily suspended in March 2020 to allow Eurozone states to implement stabilisation policies. They are scheduled to be reactivated in 2023.

For the vast majority of economists, the Stability and Growth Pact framework is obsolete. Let's recall that keeping identical numerical thresholds for each country in terms of debt (60% of GDP) and deficit (3% of GDP) has no theoretical basis. The fixed-debt threshold is a target that has become too far removed from reality for many countries.

The current rules have proven to be pro-cyclical and therefore counterproductive, especially after the sovereign debt crisis. The deficit rule is based on estimates of structural (i.e. cyclically adjusted) deficits, which are by nature unobservable. Different methods are used to assess them, but none of them is unanimously accepted, provoking endless debate. And methodological problems are exacerbated by major recessions.

Even before the Covid-19 crisis, the effectiveness of the fiscal rules had already been questioned and many economists had called for reform[1].

The reactivation of the fiscal rules as they stand – scheduled for 2023 – would lead economies still weakened by the crisis to implement restrictive policies, ultimately proving counterproductive to the sustainability of their debt (with, as a consequence, a further increase in the debt-to-GDP ratio).

In a monetary union, fiscal coordination is necessary...

In a monetary union, it is necessary to coordinate fiscal policies in order to avoid the negative consequences associated with excessively loose fiscal policies by members of the union. If one-size-fits-all rules are no longer appropriate, **a new credible and coherent fiscal framework must therefore be found.** Since the Maastricht Treaty, the European fiscal rules have been amended several times without significant treaty changes. There is therefore no institutional obstacle[2].

- The Covid crisis led countries to implement stabilisation policies that increased their public debt. Ironically, it was the countries with the highest debt levels before the Covid crisis that experienced the most significant increase in public debt.
- **Countries do not face the same macroeconomic constraints.** It is therefore neither desirable nor credible to maintain a single rule.
- **The central issue has become the sustainability of public debt.** Debt sustainability depends fundamentally on the gap between bond yields and GDP growth and on the capacity of a government to maintain a sufficient primary surplus. This type of analysis is by nature country-specific. The analytical framework must be enriched by taking into account a battery of indicators: the primary deficit, the level of the debt-to-GDP ratio, the debt maturity, the interest rates/debt burden, the potential growth.

Too many objectives are assigned to fiscal policy alone

... but the link between monetary and fiscal policy must be rethought when interest rates can no longer be reduced

- **Unconventional monetary policies implicitly call for unconventional fiscal policies.** The current low interest rates (much lower than GDP growth) naturally give governments more room for manoeuvre to implement stabilisation policies or public investment programmes. This is all the more necessary as monetary policy is less effective when interest rates are close to zero.
- **However, Europe cannot abandon fiscal discipline just because interest rates are low.** Interest rates could eventually rise and put the most indebted countries in serious difficulty. The Eurozone member states cannot take this risk. Let us remember that the monetisation of public debt is not compatible with the functioning of the European monetary union, and that it increases the risks of financial instability in the medium term (through the impact on financial and real asset prices).

[1] *Bénassy-Quéré et al. 2018, Darvas et al. 2018, Feld et al. 2018, Thygesen et al. 2018. And more recently, Martin, Pisani-Ferry, Ragot (2021).*

[2] *In practice, states will have to rewrite the core provisions of the Treaty on the Functioning of the European Union (TFEU). In particular article 126 ("Member States shall avoid excessive government deficits").*

THEMATIC GLOBAL VIEWS

Rethinking the European fiscal framework: abandoning uniform numerical targets without abandoning fiscal discipline

Reform needs unanimity, and unanimity is out of reach in the short term

- **The Covid crisis has clearly shown that the fiscal framework was inappropriate.** The new framework will have to provide for aid to states in difficulty in exceptional circumstances (in response to an exogenous shock that does not present a moral hazard).
- **With the NGEU, the Eurozone has taken a significant step towards debt mutualisation.** The appetite for securities issued by the NGEU shows that investors welcome this move. But it should be remembered that this mechanism is temporary. The common debt could certainly be mobilised again in the future in exceptional circumstances. But this assumes that the States continue with structural reforms and do not abandon fiscal discipline.
- **However, too many objectives are currently assigned to fiscal policy alone:** energy transition, financing infrastructure and education investments, cyclical stabilisation.
- Furthermore, the need to distinguish between operating and capital expenditure is often emphasised. Governments cannot avoid the issue of the "quality" of spending. Fiscal discipline must first and foremost focus on "unproductive spending". Investment expenditures must be protected.
- **The establishment of a new fiscal framework requires unanimous agreement.** In order to convince the most virtuous countries, the countries with high debts (Italy, Spain, France) will have to commit to reducing their operating expenses (by committing, for example, to keeping the growth of those expenses below that of GDP).
- **The fiscal framework will need to be sufficiently credible** to ensure that debt sustainability does not rely on the ECB.
- **In practice, it would thus be necessary to delegate to an independent body the analysis of the public finances of each state and the «recommendations» made to governments**. Since sanctions have never been applied, a system of appropriate incentives will have to be found to ensure that these recommendations are applied (e.g. some solidarity mechanisms could be conditional).

These subjects are by their very nature politically sensitive. The debate has only just begun and rapid agreement is highly unlikely. The current rules are highly symbolic, especially for the least indebted countries, which believe they already made enough concessions when the NGEU recovery fund was set up. A complete break with the Stability Pact and the old rules is therefore not realistic. But European governments can possibly agree to set aside the current rules while a new framework is negotiated.

The next coalition in Germany, probably dominated by the SPD and the Greens, might agree to move in this direction. But the FDP liberals will only agree to give up the current framework if the new fiscal framework ensures a certain discipline. **France, which will take over the EU Council in H1 2022, will probably take the opportunity to put this issue on the table.**

The adoption of a new fiscal framework would improve the resilience of the Eurozone in the event of an asymmetric external shock, thereby enhancing the credibility – and hence the attractiveness – of the Eurozone. **Investors will be more sensitive to the definition of a coherent fiscal framework than to the maintenance of numerical targets which have never been met in practice.** This should encourage governments to reach an agreement, as the credibility of the union is a prerequisite for the internationalisation of the euro, which is an objective shared by all..

Finalised on 01/10/2021

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Covid headwinds ease as China risks rise

At the time when EMs are navigating towards a healthier environment (Covid cases numbers shifting downward and vaccination rollouts speeding up), China's self-induced deceleration is now looming. Those economies that are most exposed to China (i.e., based on trade and commodities) with limited policy room are the ones most at risk. EM debt is still a good source of carry; we do prefer local rates, where CBs are closer to the end of their normalisation cycle. We are cautious but constructive on EM equities, whose valuations are attractive by global standards.

Alessia BERARDI,
Head of Emerging Macro and Strategy Research

Claire HUANG,
Senior EM Macro Strategist

Yerlan SYZDYKOV,
Global Head of Emerging Markets

EM macro context: growth trends, inflation dynamics and policy mix

Starting in July, economic momentum in the EM stabilised at strong levels in Latin America and Eastern Europe, while it has remained moderate in Asia. Asian countries have been suffering from a ravaging Delta variant, as well as lower tolerance by the authorities to the spread of the virus. Indeed, stricter and stricter lockdowns have been enforced since June in the region. The months of August and early September brought some good news in Asia on the pandemic front: the number of cases has peaked (though at different paces) and some restrictions have been lifted across Asia. Recent figures in Indonesia have been showing the smallest number of cases (on a seven-day average) in almost one year; in mid-September it reopened to foreign tourists (fully vaccinated and with a quarantine ranging from eight to 14 days). In the meantime, the vaccination rollout has sped up, though it remains slow.

The growth rebound since EMs reopened their economies has been driven mainly by external demand (especially among commodity exporters through very favourable terms of trade) and by household consumption (supported by pent-up demand and/or cash handouts). In contrast, **the recovery in investments continues to lag and is even absent in the worst cases, making the current rebound less self-sustainable going forward.** For that reason, the policy mix should remain supportive and only gradually normalise towards more neutral financial conditions and a more prudent fiscal stance. **Global financial conditions have been allowing EMs to maintain a supportive policy stance so far;** indeed, the Federal Reserve's recently well-telegraphed tapering plan has been well received by the markets, reducing for the time being the potential disruptive power of vulnerable external conditions across EMs. Of course, it helps that balances of payments are sounder in comparison with those at the taper tantrum episode. Unfortunately, stretched EM inflation dynamics have already challenged many EM central banks to start normalising their monetary policies. The pressure on inflation from costs (food, energy, and shipping rates) is in any case near to smoothing out. As a reminder of where the EM policy mix stands, the bold hiking cycle already put through (like in Brazil and Russia or in other recent hikers, like Colombia, Chile or Hungary) and the ones projected are making it possible to continue normalising liquidity conditions at a very gradual pace.

China: a "new" source of macro-financial stress for the global economy and emerging markets

Against a still fragile EM backdrop, the greater-than-expected slowdown in the Chinese economy started to manifest itself in July and August.

Growth numbers broadly surprised on the downside in Q3, with exports being the only exception. Policy tightening with the housing slowdown, self-imposed restraints (zero-tolerance Covid-19 policies and de-carbonisation production cuts and electricity rationing) and the global chip shortage have all contributed to a weaker economic performance.

For the second time in less than two months, we have downgraded our growth forecasts; we no longer expect growth to recover to trend in Q4 2021. Still, we do expect a production comeback in Q1 2022 as global supply constraints ease and as energy use quotas are renewed. Moreover, we still expect some adjustments to the zero-tolerance policy for easier domestic travel in early 2022, which should become less of a drag on the services sector. **We now expect average 2021 real GDP growth at 8.3%, down from 8.7% previously, and 2022 growth at 4.9%, against 5.4% previously.**

Activity in the housing sector is cooling fast, and liquidity pressure will remain high for the sector, barring any policy changes. Under a new regime of regulations introduced a year ago, developers will need to meet the deleveraging goals by mid-2023. Deleveraging the housing sector and stabilising housing prices suit China's long-term political agenda. To pursue Common Prosperity, the government is promoting a sustainable and healthy housing market for the greater good. Hong Kong and South Korea are constant reminders to Beijing of how elevated housing inflation could quickly erode household income and political bases. On the back of China's general commitment to financial de-risking, companies like the developer Evergrande will need to restructure

Deleveraging the housing sector and stabilising housing prices suit China long-term political agenda

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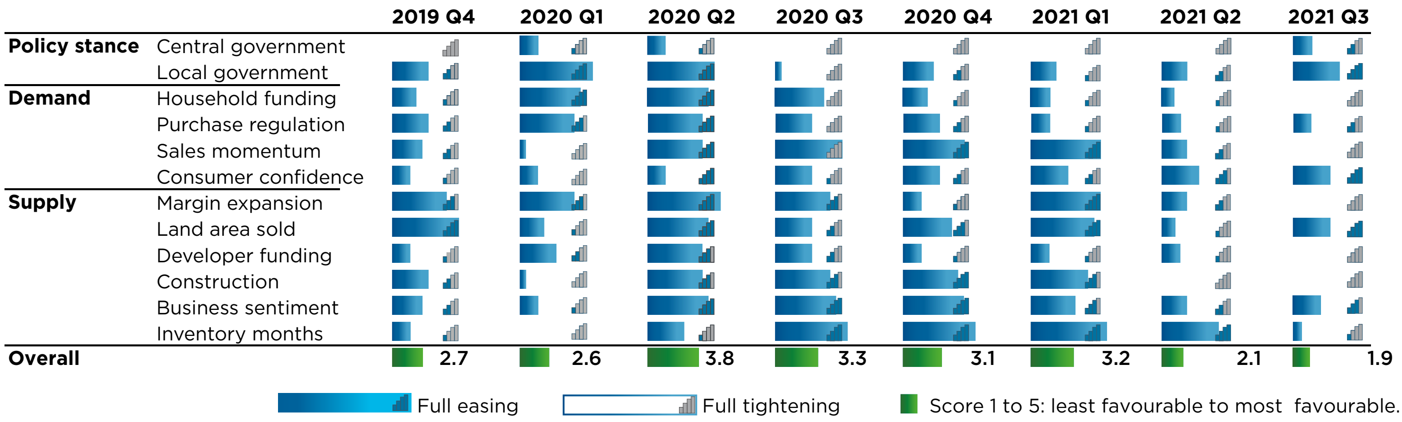
their debt stock. **The real contagion, in China and abroad, from housing sector re-sizing is combining with the financial contagion starting from the property sector in the Asian credit market and questions on banking sector exposure.**

1/ China property scorecard



Source: CEIC, GS, Amundi Research - As of 15 September 2021

Among the positive catalysts for growth, on-budget fiscal is loosening with high net issuance expected to continue in September and December. The fiscal loosening should lift infra investment out of contraction, but a recovery to the low single-digits is more likely, given the higher project quality requirements and the cautious stance of local officials before the March NPC and the 2022 Party Congress. Nevertheless, we don't expect any relaxation of off-budget debt controls yet, limiting the spending from LGFVs and Local SOEs. Credit growth is bottoming out. Deleveraging in 2022 is likely to continue at a slower pace than in 2021 YTD, in order to prevent contagion risks. The PBoC should maintain loose interbank liquidity. The recent weekly liquidity injection amount was the highest in eight months, in part to meet seasonal demand. **We expect PBoC to cut the RRR again in October. However, the RRR cut alone won't help much.** The current weakness in the economy requires a suspension of tightening in credit, or a rate cut (which would be less effective without credit loosening). But there is no signal from the central bank that it intends to do so.

EM with higher exposure to China (Trade and Commodity) with limited policy room, the most at risk

China slowdown: what is the impact on EMs?

The slowdown expected in the Chinese economy should normally impact most economies across the globe. On a pure macroeconomic perspective, we have been analysing this impact along different dimensions. **The first and more direct impact is expected to be through the trade channel,** due to China's huge relevance as trading partner for many countries in the world. The first take-away in analysing the figures based on value-added trade exposure, is that, with the exception of Australia and Japan, EMs will suffer a stronger impact from a downside shock on Chinese growth than DMs. Among the EMs, generally speaking, if we put aside the regional proximity of Taiwan or South Korea, commodity exporters will be the countries more penalised, and this is already evident simply through the trade channel. However, in consideration of the negative drivers that we assume are impacting Chinese growth the most, **we want to emphasise the importance of a re-sizing housing sector (not completely offset by mildly improving infrastructure investments), while assigning a more negative rank to countries exporting metals than fuels or agro commodities.**

Moving away from a proper direct impact from the Chinese slowdown, it's worth assessing how much policy room (monetary and fiscal) is available across EMs to offset this kind of external shock on growth. **EM monetary policy room depends mainly on two aspects, external global financial conditions and domestic macro conditions (namely growth and inflation).** While in our outlook the global financial conditions driven by the main CBs' stance are tilting towards tightening, there is still some asynchrony among them, and the narrative of "not enough growth" continues to dominate the theme of more persistent than expected inflation. Therefore, even if not compelling yet in discriminating certain EMs versus others, in a changing global context we need to be mindful of where the external vulnerabilities are today. The crisis has triggered a nice external rebalancing that some countries are currently seeing deteriorating slightly on the back of their domestic economic rebound. While global conditions have been giving EM CBs time to adjust their exceptional dovishness, domestic conditions and inflation above all are significantly reducing their room for manoeuvre. The tightening process in EMs has only accelerated, and the ability to scale it down is far from possible in the near term, with the exception of EM Asia, where policy normalisation hasn't even started (with the exceptions of China and South Korea). As for fiscal room, it's fair to say that the pandemic

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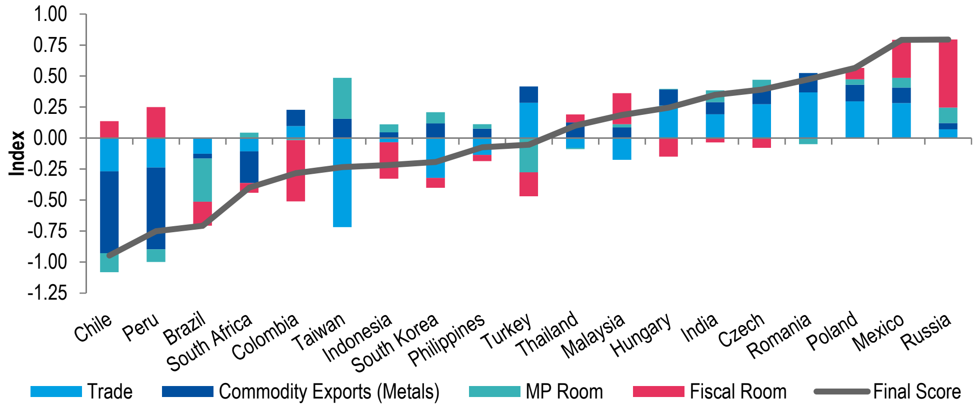
has deteriorated all countries' fiscal positions with no exceptions. In comparison with DMs, the fiscal deterioration in EMs has been due more to revenues shortage due to poor economic performance than to the strategically important fiscal packages put in place (with cash handouts, social assistance/subsidies, and health sector support being the main tools). Beyond the general deterioration, the pre-pandemic fiscal fragilities, which have not significantly changed in relative to post-pandemic conditions, are still shaping EM relative fiscal room: Brazil, Colombia or Indonesia will have some issues in finding new fiscal room, unlike Russia and Mexico.

2/ **Chinese slowdown impact**



Sources: OECD, WTO, CEIC, Bloomberg, IMF, Amundi Research - Data as of September 2021.

EM fixed income. With rising rates and increasing inflation, could EM debt still provide a source of carry for global investors?

Inflation has continued to surprise on the upside, in both EMs and DMs, driven by strong domestic demand and supply bottlenecks. We are monitoring inflation to understand how sticky it proves to be. We think it is still too early to make a definitive call on the transitory-versus-structural inflation debate and do not expect rates hikes in DMs for at least another year. However, core market rates are too low and we therefore expect rates to pick up from the current levels. Hence, our bearish view on duration.

EM debt is still a good source of carry; we do prefer local rates, when CBs are closer to the end of their normalisation cycle

Our forecast on 10-year US Treasury yields is for a gradual rise in rates to 1.6-1.8% (vs. 1.5% at this writing). The Fed should remain data-dependant, in our view, with the current macro configuration pointing towards a reduced risk of a rapid normalisation, despite inflation prints continuing to surprise on the upside. Although tapering remains a risk and is forecast to start as early as November, the Fed's early flagging and gradualist approach amidst softer macro data should help to mitigate a 'tantrum' scenario. We think that, instead of fearing Fed policy normalisation, investors should welcome it, as it would mark confidence in the sustainability of growth.

Against a backdrop of gradually rising yields, which are still low compared to historical levels, emerging market debt continues to offer the potential of an attractive yield pick-up, across both local and hard currency debt. The local currency benchmark is yielding approximately 5% and in hard currency, and spreads are around 335 bps. While we do not expect significant spread compression this year, we continue to believe that EM debt provides a source of carry. However, given the divergent paths of EM economies, selection remains key. We remain constructive on the asset class over the long term and view emerging markets' resilience as evidence for its ability to perform once its relative growth rate improves.

In our view, inflation should be less of a concern for hard currency spreads – in fact, higher inflation is boosting nominal GDP growth in countries such as Brazil, bringing debt/GDP ratios lower than expected, whilst the surprise element of inflation is helping to boost primary fiscal balances – this is a positive for credit. We maintain our constructive outlook on EM hard currency debt overall.

In local currencies, while we do not think it is time to buy EM rates indiscriminately at this stage, as much of the sell-off has been warranted by a turn in central bank policy inclination away from easing towards tightening, and by the emergence of inflationary pressures. Having said that, **we have moved to a more positive bias on EM rates compared to the beginning of the year.** While overall local rates markets appear expensive, we see local rates to be a lot closer to fair value in many EM countries than they are in core rates markets. Therefore, we continue to favour countries where EM tightening cycles are closer to the end rather than the start of a hiking cycle.

Within EM corporates, although spreads do not look cheap on a historical basis, they appear attractive compared to other asset classes, particularly in DMs. We are focusing on bottom-up selection and continue to see attractive carry opportunities with earnings recovery continuing in 2021. The EM HY space continues to offer more value in our opinion as these credits are supported by

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improving fundamentals and lower sensitivity to US rates. We are positive on Mexico energy where spreads have been attractive; we are focusing on quasi-sovereign names here as they serve as the most liquid beta. We think exposure to the US economy will help fuel growth in Mexico, as well. Trade between the countries has been recovering, even as cyclical indicators are improving. We also like the utilities sector in Ukraine. In terms of risks, we are closely watching revisions in macro growth expectations for 2022 and their impact on earnings growth. We are also monitoring the contagion from the Evergrande saga. The need to bring leverage down across China's real estate sector, triggered by regulatory pressures and tighter monetary conditions, could weigh on growth in the sector but should bring a necessary adjustment to issuers' financial profiles and benefit the sector in the medium to long term. Technicals have been weak, due to idiosyncratic stories, but we believe that this should improve over time. On the micro level, we assign a high likelihood to the government's intervening in the restructuring process, as it will not want to see Evergrande restructure in a disorderly manner. On the macro level, we expect steps to provide more liquidity to the sector.

EM FX

Overall, we have dialled down our bullishness on EM FXs, given their strong performance following the latest US data, which are pointing towards a much slower labour market versus much higher than expected wage growth. It is not clear to us that this set of data should trigger further weakness in the USD, given the data's stagflationary flavour, which is the most feared market environment for risk assets. **We do not see great risk-reward in EM FX at this juncture and hence hold a neutral view, with a preference for currencies that may have lagged the rally but whose fundamentals and positioning are supportive.**

We have downgraded our view on the Brazilian real and are now neutral given the currency's outperformance versus other EM high yielders year-to-date. While the currency suffers from political noise, we believe that the broader macro backdrop of strong growth, healthy balances of payments, and tightening monetary policy should ultimately prove supportive.

We are now more cautious on the Mexican peso, given the currency's strong performance this year, despite a half-hearted tightening cycle by the central bank. The currency may also face downward pressure from a US economy with negative delta on growth.

Meanwhile, we are constructive on the Colombian peso, as we believe that forced selling due to the country's downgrade to HY should be behind us. Meanwhile, we have turned more negative on the Chilean peso.

In CE/EMEA, the key change has been a shift towards a positive view on the Polish zloty. The currency has significantly underperformed its regional peers. In our view, the persistently high inflationary prints may force the perma-dovish central bank towards a more hawkish stance at its upcoming monetary policy meetings. In the rest of the region, we maintain a positive view on the Russian rouble, while we are neutral elsewhere.

EM Equities. What are the main catalysts and risks for investing in EM equities?

Cautious but constructive on EM equities, whose valuations are attractive by global standards

We have a cautious but constructive view on emerging markets equities. While emerging market countries have clearly lagged US and Europe in terms of vaccination roll-outs, we are seeing increasing efforts to accelerate vaccination programs. Our base case remains that this should be enough for Covid-19 outbreaks to be controlled, even if the emergence of new variants continues to slow down the pace of reopenings.

The Fed's less dovish stance is clearly positive, as it reduces the probability of economies going through a sustained period of overheating. It also anchors inflation expectations at lower levels while reinforcing the view that inflationary pressure is more likely temporary. Overall, this is very positive for emerging markets as it decreases significantly the tail risk of sharper rates hikes.

While EM equity valuations are no longer depressed on an absolute basis, they remain very attractive in a global context, particularly for long-term investors. Earnings have started to rebound in line with economic growth, but remain far below 2019 levels. We expect normalisation of earnings and profitability to remain supportive for markets.

On a longer-term view, we continue to think that improvement in capital expenditure discipline, the lack of major macroeconomic imbalances, and increasing payout ratios should help emerging economies reduce economic and profit volatility.

Our highest conviction country view is on India, as it appears to be in the early stages of an earnings upcycle. We are also positive on Russia, given its solid macro-economic resilience, central bank credibility and compelling valuations. Meanwhile, we are exercising caution on China amidst the tightening of regulatory conditions, which is putting earnings and multiples at risk. We are also cautious on Mexico, given the deterioration of fundamentals due to the government's poor management of the pandemic. By sector, our favourite idea is consumer discretionaries, which are being supported by the reopening of global trade activity and attractive valuations. On the other hand, our least favourite sectors are healthcare and consumer staples.

Finalised on 28/09/2021

THEMATIC

Valentine AINOUZ,
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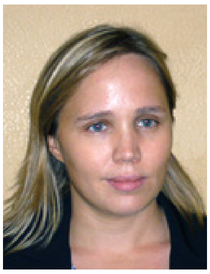


Delphine GEORGES,
Senior Fixed Income Research Strategist

Fixed Income markets: what will be key?

Eurozone and US sovereign bond markets have partially reversed the decline recorded over the summer. The decline in yields was driven by global growth concerns and abundant liquidity. How can fixed-income investors position themselves today?

Long-term yields have declined despite the ongoing strong recovery from the crisis, high inflation data and expectations among market participants that central banks globally may gradually slow their asset purchases in the near future. The decline in yields was driven by global growth concerns and abundant liquidity. Indeed, the United States and China have shown signs of slowing, which have prompted investors to revise their growth forecasts downwards. We have identified three important question for fixed-income investors:

1. The global economy has passed the peak of the pandemic recovery and a slowdown after this V-shaped recovery is, of course, inevitable. How smooth will the slowdown be?
2. Inflation data surprised investors on the upside. What is key to the inflation debate? Should we consider the current inflationary surge as transitory?
3. What will this crisis's impact be on potential growth?

The shape of the global slowdown after the recovery peaks will be key. Global growth is projected at 6% in 2021, before moderating to 4.4% in 2022. Three factors to watch: the Covid-19 pandemic, the slowdown in the Chinese economy, and the post-Covid deleveraging of economies.

- **The pandemic will continue to weigh on growth and keep the level of uncertainty high.** The vaccination rate remains low in emerging countries. The Asia-Pacific region has taken a zero-tolerance approach to new Covid cases and has been willing to impose new lockdowns. China's services activity has 'plunged' after coronavirus flare-ups. In North America and Europe, the Delta variant has had less impact on mobility and business conditions. However, the Delta variant is likely to prolong supply bottlenecks. Bottlenecks are weighing on the recovery by limiting supply, replenishment and investment. More companies in more sectors are subject to supply constraints. Transportation costs from China to Europe and the US have increased seven- to 10-fold over the past year. Delivery times have lengthened to rather extreme levels.
- **The slowdown of the Chinese economy needs to be monitored.** Besides the impact of the pandemic, Chinese economic activity could be affected by the government's willingness to implement structural changes. China's growth over the past decade came at a price, in the form of rising debt and social inequalities. Thereupon, the pandemic led to a 30% surge in debt and a heightening of social inequalities
  - Delivering "common prosperity" has emerged in recent months as an underlying theme of Chinese political discussion. The Chinese government is not prioritising growth as it once did, but instead is trying to curb unbridled capitalism, whether the power of big tech companies or rising economic inequality. These structural changes are positive for medium-term growth, but will they could come at the expense of short-term growth. Indeed, China has already made the debt-reduction campaign a 2021 priority, and this slower credit growth is contributing directly to lower activity.
  - Evergrande is a consequence of these political changes. The tightening of real estate regulations and the terms for granting loans have exacerbated the difficulties of the country's second-largest developer. In China, the real-estate sector in the broad sense accounts for almost 30% of gross domestic product. For Beijing, the stakes are high: to limit the excesses of an over-indebted sector without causing a general collapse.
- **After the surge in debt to fight the pandemic, certain deleveraging trends are also emerging in developed economies.** (1) Governments are reducing their support, with the expiry of unemployment benefits and business aid; (2) companies are using their profits massively to reduce their indebtedness; and (3) pandemic household savings are being used to buy assets and pay down or pay off credit card debt, rather than for consumption.

After the surge in debt to fight the pandemic, certain deleveraging trends are emerging

The surge in inflation will last longer than expected. Labour markets hold the key.

- **The surge in inflation is so far a Covid and a growth story that will last longer than expected.** Much of the increase in inflation results from the distortions caused by Covid, as a small group of items such as used cars and holiday accommodations explain most of the price increases seen in recent months. However, we expect current supply chain disruptions to last until the end of 2022 and the historically low level of industrial inventories will also drive demand next year.
- **In the medium term, climate-change battle and the huge economic transformation underway will also play a key role in the inflation trajectory.**
- The risk is, if prices continue to rise, that consumers will adjust their expectations, causing them to demand larger wage

THEMATIC

increases. This mechanism could potentially create a self-sustaining price-wage loop. This vicious circle would destabilise the economy and require the intervention of central bankers.

Labour markets hold key to inflation debate

For the Fed, the way is narrow: it has to normalise its monetary policy so as not to appear too far behind the curve and fuel financial imbalances, but without causing a sell-off in risky assets and a solvency crisis, given the economy's level of debt.

- Staying too long behind the curve could be a risk for the inflation trajectory with a risk of loss of credibility. Powell recognized that inflation is elevated but the spike in inflation continued to be viewed as temporary. According to FOMC members, inflation should remain above the Fed's 2% target across the forecast horizon (at 2.1% for 2024).
- These historically low real interest rates are contributing to the build-up of financial imbalances. Record low real interest rates are contributing to the build-up of financial imbalances, including record levels of M&A and share buybacks, huge activity on the US primary market, soaring US real estate prices, increased inequalities, etc. A too abrupt normalisation of monetary policy poses a risk of an asset sell-off and a rise in delinquency rates, given record asset prices and debt levels. Indeed, the net worth of US households as a percentage of disposable personal income has climbed to new heights.

Fixed-income market: liquidity and technicals have also been major drivers. Real yields are at historical lows despite the recovery.

Liquidity played a key role in the recent decline in yields

Concerns about global growth explain part of the decline in US rates, but technical factors (liquidity, flows and positioning) have also played an important role in the sharp drop of yields in since Q2.

Since February, the US Treasury department has used a huge amount of its cash deposited with the Fed at the Treasury General Account (TGA) to finance the deficit. The Treasury cash balance has declined significantly, from $1,568bn mid-February to below $100bn! When the US Treasury uses the TGA cash, it transfers its liquidity to the banking system. Banks reserves have soared, with QE and TGA liquidity leading to a renewed surge in global liquidity and a broad-based reach for yields underpinning a strong rally in risk assets, as well as US government bonds.

Strong demand for US bonds

Real yields are at historical lows despite a record supply of bonds in a striking illustration of the strong demand for US bonds. The net bond supply to the market (i.e., net of Fed purchase) has reached a historical record of $1,700bn. Meanwhile, real yields have stayed stubbornly low despite the recovery, even reaching an historical low of -1.20% at the end of July.

US banks have, of course, been a strong source of demand. Banks deposits have increased sharply, but their customers on the other hand are taking out fewer loans. As companies and households have plenty of cash, their willingness to borrow has weakened, and the Delta variant is complicating reopening plans. As a result, banks have had little choice but to buy government debt rather than keeping all their excess deposits in cash. In the past few months, banks have bought a record amount of Treasuries. On the other hand, the Fed is managing the cash flood through the RRP facility, which has reached record levels recently.

Another important source of demand has been the increase in net inflows into US bond mutual funds and exchange traded funds. A significant part of household savings – which increased during the pandemic – has been used to buy financials assets. Despite expectations that inflation fears would erode the appeal of fixed-income funds, bond mutual funds and exchange traded funds added $372bn in the first half of the year (vs. $446bn of inflows for the whole 2020 and $459bn for 2019).

The rise in long term yields will be limited by the high level of debt

Low term premiums

Following the recent rally in bonds, term premiums have reached very depressed levels. Financial markets seem to believe that the neutral real interest rate is extremely low. The 5Y5Y real which is a proxy of the market's estimate of the neutral rate currently stands at -0.40%. This is an unsustainably low level that indicates a strong overvaluation.

We expect a moderate rise in yields over the coming months

We expect the impact of liquidity on the bond market to diminish in the coming months with the Fed's tapering and the end of the Treasury Department's cash drawdown. As a result, yields are expected to rise, driven by the correction of a valuation overshoot above-trend growth. The Fed is preparing the ground for a withdrawal of stimulus, and if the economy progresses as expected it can start a tightening cycle without hurting the economy. Fiscal policy should also pay a role, as we expect additional fiscal plans to be approved by the end of the year. This inflection point in monetary policy should also contribute to a rise in long yields. The rise in long yields will be limited by the post-Covid deleveraging of economies and the high level of debt.

Finalised on 01/10/2021

CENTRAL & ALTERNATIVE SCENARIOS (12 TO 18 MONTHS HORIZON)

Monthly update

We are maintaining the narrative and the probabilities of the scenarios. The central scenario assumes that the policy mix and improving fundamentals will support the recovery and the markets. Beyond 18 months, we expect US growth to revert to potential amidst a higher inflation regime, while stagflationary pressures rise, in particular across Europe. As valuations are stretched and economic momentum is fading, equities' expected risk-adjusted return of equities is diminishing. We now consider vaccine-resistant virus variants or vaccination-related issues as a risk to the central scenario.

DOWNSIDE SCENARIO 25%

Slumpflation

Analysis

- **Recovery undermined** by pandemic-related constraints, despite successful vaccination campaigns
- **Growth** in Advanced Economies (AEs) back at (or below) potential, despite fiscal support
- **Persistent inflationary pressures** due to prolonged supply-chain bottlenecks
- China **slowdown** and regulation crackdowns impact AEs
- **Economic and financial fragilities** exacerbated by tighter financial conditions
- **Falling** medium-term **growth expectations** and higher interest rates undermine public debt sustainability and limit fiscal support
- **Protectionism** and **de-globalisation,** affecting trade and value chains
- **Stagflationary** pressures exacerbated by deleveraging and bottlenecks

Market implications

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

CENTRAL SCENARIO 60%

Multi-speed recovery

Analysis

- **Strong but uneven multi-speed** recovery in 2022 followed by a mild slowdown in 2023
- **Supportive policy mix** allowing debt to GDP ratios to stabilise
- AEs monetary policies to normalise gradually starting with the Fed
- **Narrower growth premium gap** between EMs and AEs (US policy boosters and China's deceleration)
- US growth and inflation peaked in Q2 and normalise gradually; EZ growth and inflation to peak in H2; China negative growth in Q3, weak in Q4 and a rebound in 1Q22
- **NGEU** execution is **diluted,** despite political commitment
- **Lower solvency risk** thanks to positive corporate earnings momentum, active deleveraging and low funding costs
- **Income and wealth inequalities** increase social and political tensions

Market implications

— Lower risk-adjusted expected returns due to high valuations and decelerating growth
— Contained steepening of US Treasuries yield curve as well as EZ and EM
— Favour equity momentum and quality
— Inflation hedge via gold, linkers and equities
— Favour barbell positioning in the currencies space
— EM: Short-term caution, long-term income and growth story intact

UPSIDE SCENARIO 15%

Sustainable & inclusive recovery

Analysis

- Mass vaccinations enables a **full global recovery**
- Closing gap between manufacturing and service sectors
- **Consumption strength** driven by savings and increased disposable income
- The Fed **normalisation is very gradual** despite the US job market recovery and wage pressures
- **NGEU** implementation is a **success**
- **Virtuous circle** of growth and inflation without global overheating
- **Inclusive** and sustainable recovery
- **Higher potential growth** thanks to productivity gains driven by digital and green developments

Market implications

— US Treasuries curves bear steepen
— Favour risky assets with cyclical and value exposure
— Favour linkers as an inflation hedge

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 make no change to the probabilities of the risks to the central scenario. We consider Covid-19- related risks, as part of the economic risks. Risks are clustered to ease the detection of hedging strategies, but they are obviously linked.

ECONOMIC RISK 20%

- **Pandemic 2.0**
  - Despite mass vaccinations, a 4th Covid wave kicks in. New variants with limited vaccine efficacy undermine the economic recovery (new lockdowns or mobility restrictions)
  - Supply chain bottlenecks carries on and input cost pressures lead to corporate earnings recession
- **Global tightening**
  - As inflation expectations rise, the Fed and other DM central banks could tighten financing conditions too early and hurt the recovery
  - Central banks' miscommunication could be sources of uncertainty
- **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

+ 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
  - 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, and could lead to 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 20%

- **US & Europe vs. China cold peace**
  - US takes a hard line with China
  - Sanctions, disclosures requirements and delistings of Chinese companies are signs of escalation
  - European countries could follow the US, despite their economic interests
  - Lost influence of the US post Afghanistan exit
  - Possible accidental confrontations in the South China Sea or the Taiwan Strait
- **European populist vote,** in France or Italy on the back of the Covid crisis and underestimated hysteresis effects in the labour market could lead to a further fragmentation of the EU
- **EM political instability driven by:**
  - Chaotic virus crisis management and public debt level
  - Higher food prices leading to a wave of unrest in EM similar to the Arab Spring
- **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

Covid-19 situation update

Pierre BLANCHET, *Head of Investment Intelligence*

The feared, post-summer fourth wave in the Northern hemisphere doesn't seem to have spread, despite the Delta variant's high transmission rate. According to the latest WHO data, the weekly number of cases is actually diminishing. Europe and the US have seen a pick-up from late August through September but nothing close to previous waves. The mortality rate is also falling (to a global average of close to 1.6%, according to the WHO). The number of Covid-19 deaths in persons who had received both vaccine doses and had a first positive PCR test at least 14 days after the second vaccination dose, is very low across the regions. Although we cannot exclude the risk of a new, dangerous variant, the main concerns are now the low level of vaccinations in many emerging market countries and the lack of progress in some advanced economies, such as the US, where only 56% of the population is fully vaccinated. Logistics and trade deal issues explain the delay in lower-income countries. Lack of trust in science and the health system explains the slow motion in the US. Consequently, herd immunity is unlikely to be reached soon, and the pandemic will still be with us for several more quarters.

CROSS ASSET DISPATCH: Detecting markets turning points

Monthly update: The traffic light on economic backdrop has turned from green to orange

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

ECONOMIC BACKDROP

- Economic activity expanded at a solid pace over the third quarter in the Eurozone, benefiting from the easing of Covid-19 restrictions during the summer. Growth is expected to remain strong, although high frequency and soft data are pointing to a progressive flattening. The consensus continues to adjust downward, while economic surprises remain negative.
- Economic activity in the US continues to grow at a sustained rate, although growth rates are expected to progressively moderate as confirmed by the ongoing flattening of high frequency indicators and soft data. The CESI Index remains in negative territory, as both soft and hard data failed to deliver positive surprises. The consensus continues to moderate, remaining, however, in positive territory.

FUNDAMENTALS & VALUATION

- Most equities stabilised at all-time highs, as the recovery in profits began to consolidate, as valuations looked expensive, and as earnings are vulnerable to downward revisions.
- CB liquidity injection is still the only argument for the markets' high levels, although the start of tapering should erode investors' complacency.
- Absolute PE levels are above historical trends.

NEUTRAL + ASSET ALLOCATION

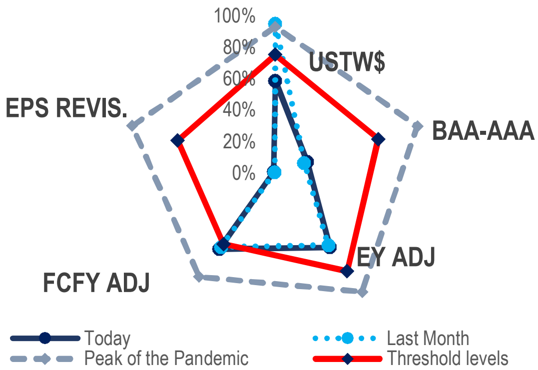
TECHNICALS

- There were some shifts in contributions with respect to the last month from our technical toolbox.
- RSIs were in overbought territory but moved into less stretched territory after their recent pullback.
- Technicals remain mixed, with a lack of directional bias at the time of writing.

SENTIMENT

- With the Fed set to tighten its monetary policy, with concerns over Evergrande's defaulting on its interest payments, and with growth momentum decelerating, volatility in risky assets rose in September, and risk appetite moderated with respect to last month.
- Most risk sentiment metrics we track, though, are still far from pure risk-off levels and keep showing moderately constructive risk sentiment in the market. Financial conditions remain loose in most regions, whilst EPS revisions are more than compensating for both the USD and the drop in economic surprises (which are clearly showing early signals of risk-gyration).
- Institutional investors decreased their risk exposure ahead of Jackson Hole last month and are neutral to longish on risk as we speak.

Cross Asset Sentinels Thresholds (CAST) still supportive



Source: Amundi Research, Data as of 23 September 2021

CAST risk perception is increasing, but we are far from structural risk off signal. Central banks are keeping credit risk premia low and earnings revisions are balancing the risk off signal coming from the USD. Visibility on the next steps though is deteriorating.

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 debt ceiling and the Democrats political agenda

- The US debt ceiling and Biden's infrastructure plans are sources of tensions in Congress that are undermining short-term visibility for investors.
- Progressive Dems want to link the infrastructure bill with social spending, which conservative Dems are opposing.
- The Dems' fiscal agenda is a function of their chances of success in the mid-term elections next year. At this stage, the Reps are likely to regain control of the Senate.
- Therefore the Dems could try to pass as much fiscal reform and infrastructure spending as they can to show their impact ahead of the polls.

2 ECB recalibrating, not tapering

- ECB expected to keep its stimulus persisting into 2022, in order to support NGEU efforts on the fiscal side and ensure the economy returns to a pre-Covid path.
- We expect strong monetary support as long as economic fragmentation persists.
- Inflation forecast remain well below target. Short-term rates to remain anchored to the current lows for longer on the back of ECB forward guidance.
- The ECB flagged December as the date for decisions on PEPP and TLTROs.
- We have moved our 10-year German Bund yield target to -0.40/-0.20% (from -0.10/+0.10%).

Investment consequences:

- Slight short duration on core Euro-area sovereign
- Slight steepening of the curve.

3 Energy price increases and inflation outlook for the Eurozone

- The increase in energy costs due to the surge in post-pandemic demand faces a constrained supply. The increasing costs of CO2 emissions for companies, which are already in play for some countries in Europe, should move inflation higher in the quarters to come.
- The final impact on consumer prices and households energy bills will depend on how governments limit pass-through effects on regulated prices. Currently for the Eurozone we estimate the impact at approx. + 0.3% on the average inflation rate, concentrated more in 2022. Barring further shocks, inflation is still expected to peak in Q4 and move lower into 2022, yet the peak will be higher (significantly above 3%) and pressures slightly more persistent.

4 Equity styles rotation: introducing Momentum and Quality

- Lower bond yields and a strong earnings season have allowed US and EMU equities to hit new highs.
- Below the surface, peaking growth, negative economic surprises, Covid uncertainty, and potentially lower economic support are raising question marks and pushing towards Cyclicals/Defensives and Value/Growth consolidation.
- Part of the rotation is also due to a maturing cycle in the US.

Investment consequences:

- In both US and European equities we are introducing Momentum and Quality, the usual winners in stage two of the business cycle and a way to play relative value.
- After their rebalancing in May, Momentum indices have become cyclical/defensive proxies.

5 Cross Asset China: positive on equity and credit

- Sentiment appears to be stabilising from regulatory tightening shocks. Credit outlook is being supported by fiscal loosening.
- Flow-wise, credit impulse (i.e. new credit) is stabilising and bottoming out.
- Liquidity outlook to improve further: after growth downgrade, we expect one more 50bp universal RRR cut in Q4, and are removing 10bp hikes in early 2022.
- No rate cut is expected, given that the credit slowdown was driven mainly by supply factors, i.e. regulatory tightening on housing and local government debt sectors.

Investment consequences:

- Remain positive on equities. Prefer H-shares over A-shares. Add more to HSCEI, less to HSI and MSCI China.
- Maintain Credit exposure, preference for long duration IG (5-10yr).
- Neutral on rates.

6 Commodity super cycle update: medium term upside potential

- Post-pandemic, prices have caught up with global growth. The still-depressed inventories cycle is thought maybe to perhaps be the driver of a prolonged uptrend in the medium term.

Investment consequences:

- Long on commodities in the medium term.

AMUNDI ASSET CLASS VIEWS

	Asset Class	View	1M change	Rationale
EQUITY PLATFORM	US	=		We think the supply chain shortages and pressures on labour markets should ease later in 2021 and next year. But valuations are extreme in certain segments and hence there is an increasing need to be selective and focus on relative value. Investors should also keep in mind the potential tax hikes and stay away from names that could be hurt due to regulations brought in to deal with tax avoidance.
	US value	+		We maintain our value call supported by a mild increase in core yields, vaccinations and an ongoing recovery, even though the rebound is stabilising from peak growth levels. Thus, the need for selection is high and investors should avoid cyclical value and focus more on quality value names.
	US growth	-		We believe the recent weakening of growth momentum have led growth stocks to outperform, but their valuations are above long-term averages. As rates rise and as vaccination levels improve, this gap should come down, making the case for a cautious approach in this segment.
	Europe	=		Europe continues to emerge from the crisis with expectations of growth peaking later this year. But inflation (energy and food) seems to be getting strong amid the transition towards clean energy. In this environment, we reiterate the rotation towards value, but recommend investors broaden this to include names displaying strong quality, ESG (ESG winners of tomorrow) and dividend characteristics. Overall, the focus should be on selection and pricing power.
	Japan	=		Japanese markets witnessed uncertainty due to renewed Covid concerns but are trading at attractive relative valuations. We think the country should catch up eventually, benefitting from a weaker yen and from value and dividend themes.
	Emerging markets	=		Valuations are attractive and earnings recovery momentum remains strong in EM amid ongoing vaccination programmes and reopening. We are positive on countries such as India and Russia with strong domestic consumption potential. In terms of sectors, we like consumer discretionary, real estate and communication services, maintaining our tendency to increase value/cyclicals over growth.
FIXED INCOME PLATFORM	US govies	-		UST yields remain low when compared with economic growth dynamics and actual inflation numbers, indicating that markets have accepted the temporary narrative. However, while we lowered our 10Y yield target, we believe the path for core yields is upwards as the Fed normalises its policy and as pent-up savings and consumption come into play. We remain cautious but maintain a flexible stance. TIPS offer decent real yields, but we are watchful of valuations.
	US IG corporate	=		We prefer short-maturity debt and idiosyncratic stories (rather than market exposure) due to risks from rising core yields. Accordingly, we remain selective and vigilant as economic recovery continues with some signs of peaking from high-growth levels. We are positive on agency mortgages, but think investors should be watchful for any signs of weakness as taper discussions at the Fed continue.
	US HY corporate	=		Amid strong supply this year and improving liquidity, valuations in this segment remain high as borrowing costs for HY companies are still low. Investors should aim to limit portfolio beta and instead use credit selection to identify companies whose credit metrics are improving, thereby striking a balance between extra income and quality.
	European govies	-/=		Given the ongoing recovery in the region, inflation numbers and indications of tapering by the ECB in the near future, we maintain a cautious stance on core and semi-core European government bonds. We acknowledge the key political events in the region and remain flexible and watchful. On the other hand, we are constructive on debt of peripheral countries, particularly Italy, due to optimistic growth outlooks and the still accommodative stance maintained by the ECB.
	Euro IG corporate	=/+		We are seeing signs of a general improvement in the overall credit environment as the ratings outlook remains stable and net debt to EBITDA is declining. We believe BBBs and financial subordinated debt are in a sweet spot and offer better risk/reward profiles vs the higher-rated ones. However, we remain selective and prefer shorter maturity instruments and sectors linked to the cyclical recovery.
	Euro HY corporate	=		The HY segment presents selective opportunities as we explore names with a potential for spread compression and robust ESG profiles. We also look for rising stars, subordinated debt that may witness rating upgrades and improvement in fundamentals. However, we avoid asymmetric risk profiles where changes in core yields could affect prices.
	EM bonds HC	=/+		We prefer HC credit risk and remain constructive in the medium term with a bias to HY vs IG. Within corporates, although spreads do not look cheap on an outright basis, they appear attractive compared to alternative options.
	EM bonds LC	=		We remain watchful of headwinds from potential tightening in developed markets. In China, we think the PBoC and the government would aim to avoid any contagion and liquidity crunch. Overall, we are selective and are exploring countries where EM tightening cycles are closer to the end, such as Russia, but we remain bearish on global duration.
OTHER	Commodities			A build-up in global inventory and possible supply shortages should be positive for commodities (such as base metals) over the medium term. Precious metals such as gold could witness some volatility as the Fed normalises policy, leading to an increase in real rates. However, if growth momentum decelerates next year, we could see some upside for the yellow metal.
	Currencies			Slowing global growth and Fed's policy normalisation are likely to support the USD, especially against the low yielders (EUR, JPY, CHF). However, we remain constructive in the short term on certain cyclical currencies (NOK, GBP, CAD) whose CBs are expected to move ahead of the Fed, whose valuations are supportive, and growth path seems strong.

LEGEND

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Negative Neutral Positive Downgrade vs previous month Upgraded vs previous month

Source: Amundi, as of 26 September 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.

Amundi ASSET MANAGEMENT | Research

CROSS ASSET
INVESTMENT STRATEGY

October 2021 #10

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