Institute

#09
September 2022

CROSS ASSET
Investment Strategy

CIO VIEWS

The autumn hard vs. soft landing puzzle

AMUNDI INSTITUTE

Q2 earnings season – strong results helped support the summer rally

Confidence must be earned
Amundi
ASSET MANAGEMENT

#09 - September 2022

Table of contents

CIO VIEWS

The autumn hard vs. soft landing puzzle

Vincent MORTIER,
Group Chief Investment Officer

Matteo GERMANO,
Deputy Group Chief Investment Office

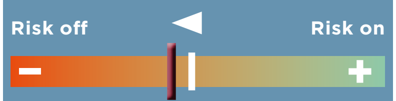
The summer season has temporarily brought some sunshine to investors as the main equity markets had been rallying until mid-August. Supporting this trend was a series of assumptions on key themes driving the market: inflation was assumed to be at its peak and starting to recede; growth was assumed to be on a soft landing path; and central banks were assumed to have done most of the work needed.

Back in June, we thought a rebound was in sight as the market had oversold amid a still-resilient US economy and this underpinned our preference for the US equity market within an overall cautious to neutral equity allocation. The main story supporting the market over the summer was the expectation of a possible pivot by the Fed, after its more-hawkish-than-expected actions so far. In a 'bad news is good news' scenario, the negative quarterly US GDP number supported this narrative. With Q2 earnings season still showing positive trends, the buoyant market environment has translated into looser financial conditions, further complicating the task for central banks. Now that the Fed has reasserted its hawkish stance, we are starting to see some further downward movements, which we think may continue as markets have further to go in the repricing of higher real rates. At this point, we see no positive triggers to keep the rally going, while there are rising risks moving into autumn amid a gloomier economic backdrop. To cope with this environment, we believe investors should adjust their asset allocation stances. In particular:

- **It's time to reduce equity exposure and become more defensive.** While a global recession may be avoided, after the recent rally there are no elements supporting a positive stance in equity markets while risks are increasing. Taking into consideration the factors that may bring volatility in the short term (CBs' communication, news flow related to the energy crisis, some global macro weakness), we have started to move to a **more cautious stance on equities.**
- **In equities, we keep our preference for the US vs. Europe and also for China, though on China to a lower extent than before amid the volatility driven by Covid restrictions and a weak housing sector.** Even if the US economy is decelerating, it remains far more resilient than Europe. With contracting margins, squeezed consumers and decelerating economic activity, there is a limit to how much pricing power and top-line growth companies can deliver. While Q3 corporate results should be resilient, we could see earnings turn negative in 2023. As a result, **overall we are now more defensive than before and particularly selective.**
- **Bonds are back, but an active approach is paramount given the still-high uncertainty.** After the great repricing in the first half of the year and as we move to an environment with a higher risk of recession, government bonds are worth looking at as yields are now more appealing. Here we recommend a tactical approach to duration management, considering markets are being driven by both inflation and growth expectations, pushing yields in different directions depending on the prevailing narrative. In credit, we remain cautious, particularly on the high yield segment. We favour the investment grade space and the US over the Eurozone, as US fundamentals are at less risk of deterioration thanks to the more resilient economy. We emphasise that an active management approach in bonds is key at this stage amid the risks of a further pick-up in inflation due to energy prices and supply chain disruptions, possibly leading to a more hawkish Fed stance than is currently priced in by the market.
- **Emerging markets (EM) offer selective opportunities.** Despite the macroeconomic headwinds, we do not see systemic risks for EM though we believe there is a higher probability of an idiosyncratic crisis, therefore a highly selective approach is needed in the EM space. Downward revisions to EM have been more subdued than for DM, confirming the growth differential in favour of EM despite the downward revision of China. In terms of investment opportunities, overall EM equity appears cheap and earnings expectations are stabilising. We look for opportunities in LatAm (Brazil) but are cautious on some Eastern European countries (Hungary and Poland). In the EM debt space, there are some interesting income opportunities and our preference is for hard currency bonds, in particular those in the high yield space.

Looking ahead, the probability of downside risks remains high while the inflationary environment is confirmed. A further fundamental deterioration could trigger another correction, with the second-round effects of monetary policy on the economy being the potential catalyst for de-risking. **Therefore, this is a time to keep a cautious view and be vigilant towards the evolution of the economic backdrop.**

Overall risk sentiment



Worsening of stagflation scenarios makes us more conservative at the margin, with a diversified, selective stance.

Changes vs. previous month

- Slightly more conservative in equities, in particular in Europe.
- Positive on US duration in multi-asset.
- Less positive on China.
- Positive IDR vs CNH.

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

AMUNDI INSTITUTE

Big picture in *short*

Monica DEFEND,
Head of Amundi Institute

The latest update on macro forecasts confirms that the stagflationary scenario is gaining momentum and affects all geographies, but with a differing intensity

Three hot questions for investors

Are we moving towards a global recession?

The growth outlook has certainly darkened over the summer, with the risk of gas rationing in Europe, a China slowdown and the technical recession in the US in the spotlight. Our central scenario has become gloomier, with downward revisions to our GDP forecasts for the US, the Eurozone, the UK and China. In Europe, a stagflationary shock looks to be a certainty, and the increasing challenges on the gas front imply that it will be prolonged, with both the last quarter of this year and the first quarter of 2023 showing negative GDP growth. In the US, a soft landing still looks to be within reach, but the risks of recession for mid-2023 have increased. The deterioration in US economic activity is not yet a product of the ongoing Fed tightening, and labour market is still strong although cracks are starting to appear. The Q2 GDP reading marked a technical recession, but the most recent estimate of it and of gross domestic income still point to an expanding economy. These inconsistencies in the data further complicate any assessment of the health of the US economy. On the China front, growth has been revised down further. The housing recovery is now foreseen to be much weaker than previously expected, but the picture is still one of recovery. For the rest of the year, we see the continuation of the post-Covid reopening and the supportive policy mix being the main drivers of the economic rebound, but the risk of recession in China should also be on investors' radars as short-term challenges persist.

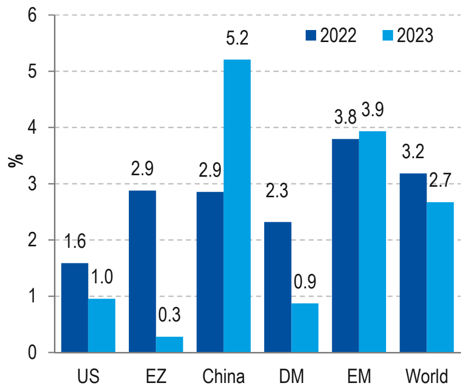
Is inflation cooling?

Inflation remains high, with CPI YoY at 8.5% for the US (down from 9.1% in June) and 8.9% in the Eurozone (up from 8.6% in June). As the global economy decelerates, bottlenecks and price pressures are easing, but remain high. This should push down goods inflation but services inflation is still picking up, causing overall inflation to stay high, although declining at different speeds across the world, with energy inflation being the key source of divergences. The Eurozone currently faces the most significant challenges. Inflation should reach a near double-digit peak in winter and then decelerate from 2023. Higher natural gas bills (the natural gas price is more than seven times higher than a year ago) may be followed by other increases. Overall, we expect inflation numbers to remain volatile and this will further complicate CBs' assessments of the effectiveness of their actions.

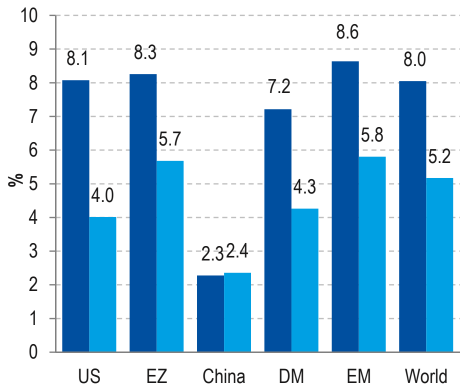
What should we expect from central banks?

Central banks remain committed to fighting inflation, as recently reaffirmed during the Jackson Hole meeting, where the hawkish message sent to the market was that curbing inflation is the top priority. However, as history has shown, CBs should not declare victory too early. With high wage growth far from the desired level and hot, albeit decelerating, inflation, the Fed will raise rates above the neutral level and we now expect a 75bp hike in September, followed by 25bp in each of the following three FOMC meetings, leading to a terminal rate of 4%. The ECB will also fight inflation and may raise rates too much. The July decision to hike rates by 50bp rather than the previously announced 25bp, drop forward guidance and become completely data-dependent went in that direction: namely, to frontload and make the best use of the limited window of opportunity before growth becomes impaired. The TPI announcement indirectly supports this more active strategy. Our expectation points to hitting a terminal rate of about 1.5% at year-end. A 0.75% hike in September is now on the cards.

Real GDP growth



CPI YoY growth



Source: Amundi Institute, DataStream, Bloomberg. Data is as of 31 August 2022. Above chart shows forecasts by Amundi Institute, as of 31 August 2022. CPI: consumer price index. DM: developed markets. EM: emerging markets.

MULTI-ASSET

Reduce risk amid high uncertainty

Francesco SANDRINI,
Head of Multi-Asset Strategies

John O'TOOLE,
Head of Multi-Asset Investment Solutions

As we wait for more clarity on the economic cycle, we see limited visibility on earnings and hence, we have become more cautious in equities, upgrading duration

Markets retracted recently despite the better-than-expected Q2 earnings because companies released subdued guidance. We think the market's earnings expectations are too optimistic, even after the recent downward revisions. As a result, we are **more cautious on risk assets** but do not think this is the time for structural de-risking. Instead, investors should adjust their exposure by adding safeguards in light of recessionary environment, particularly in Europe. Incidentally, this also makes us **more vigilant on European equities** and slightly less positive on China. On the other hand, there are opportunities to benefit from the different economic backdrops prevailing in EM. Overall, investors should explore a broad array of assets to keep a diversified stance (commodities, FX), along with sufficient hedges.

High conviction ideas

We are cautious on equities overall, even as we tactically downgrade Europe because the region is more exposed (than the US) to the worsening stagflation risks. Consequently, we remain committed to our relative preference for the US over Europe. This is because the stabilisation of real yields in the US, attractive valuations and a better environment for quality/growth markets should favour the US over Europe. In EM, we are constructive on China but believe the zero tolerance for Covid and the malaise in the housing sector will weigh on equities in the near term.

In FI, we are now slightly positive on duration through US (after US 10Y yields moved above 3.0%) but are neutral on core Europe. At this stage, a hawkish Fed is supportive of curve inversion, which should create higher short-term yields and simultaneously put downward pressures on the long-term curve. However, this does not mean we are calling a US recession. In core Europe, there is a bit more ambiguity over the ECB's policy moves. Together with controlling inflation, the ECB aims to avoid fragmentation in the EZ, for example, in Italy. We think the ECB will maintain its support for peripheral markets such as BTPs, allowing us to stay marginally constructive, but we are monitoring political events. In the UK, we are positive on 5Y real rates. We continue to believe that the BoE rate hikes priced in by the market are excessive given how weak the economy is, thereby putting less pressure on the extent to which real rates could rise. On EM bonds, we are neutral.

Corporate credit is a mixed bag and while we favour US IG over EU, we are neutral overall. Even though there is a hint of investor confidence in Europe, we remain cautious on EU credit, but keep an active eye on high-quality segments. On the other hand, the US IG market is showing strong corporate fundamentals, a better economic outlook (vs. Europe), attractive valuations and the potential to stay resilient in case of a further deterioration in credit sentiment. However, it's important to monitor the effects of inflation and CB policy on markets.

Global divergences and geopolitical tensions (flight to safe haven) are creating relative opportunities in the FX space. In EM, we are now constructive on IDR vs. CNH as the rupiah could gain from the rate hiking cycle in Indonesia and inflows into the domestic bonds market, given the country's improving fiscal position. We stay positive on Brazilian Real vs. some Eastern European commodity importer countries (Poland and Hungary). In DM, we are positive (but less so) on CHF vs. EUR given the persistent geopolitical risks, and on the USD vs. both the CAD and the EUR. With respect to the NOK, which has benefitted from a surprisingly hawkish Norwegian CB, we keep our positive view vs. the CAD. But we are monitoring the former as it is a cyclical FX which could be penalised amid a risk asset sell-off.

Risks and hedging

Risks around Q3 earnings and economic growth are growing and as a result we recommend investors keep in place all equity hedges on European and US exposures. Furthermore, the USD is likely to gain in the near term, supported by the Fed's hawkish stance. Thus investors' US hedges should reflect that.

Amundi Cross Asset Convictions

	1 month change	---	--	-	0	+	++	+++
Equities	↘		■					
Credit & EM bonds	↘				■			
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.

CGB = Chinese government bonds, EM = emerging markets, PBoC = People's Bank of China, FX = foreign exchange, IG = investment grade, HY = high yield, CBs = central banks, BTP = Italian government bonds, EMBI = EM Bonds Index, QT = quantitative tightening.

FIXED INCOME

More constructive in bonds, but selective in credit

Amaury D'ORSAY,
Head of Fixed Income

Yerlan SYZDYKOV,
Global Head of Emerging Markets

Kenneth J. TAUBES,
CIO of US Investment Management

Elevated inflation, aggressive Fed and ECB, and market expectations are driving yields and risk assets. While the view that inflation could be brought under control caused some moderation earlier, the recent hawkish comments from policymakers have put upward pressure on yields. Deteriorating economic growth, particularly in Europe, is further complicating the environment. Thus, it is important at this time to understand to what extent, if any, central banks may revise their hawkish stances to help economies navigate the upcoming recession fears. **This translates into a preference for an agile approach, and a focus on liquidity and quality across the board in risk assets.** Opportunities are available in EM bonds but we suggest being selective.

Global and European fixed income

We have a close to neutral view on duration but maintain the flexibility to alter this stance. Thus, we reduce our cautious stance slightly on the US and remain neutral/marginally defensive in core Europe. Regarding semi-core and periphery, spreads are contained, but we prefer to remain neutral /cautious on peripheral debt for now. Elsewhere, we are exploring opportunities in the UK, where we are neutral, and in Japan (cautious), but we see diversification benefits in Chinese government debt. On breakevens, we upgrade our view slightly in the US and the Euro area.

In corporate credit, we are mindful of spread decompression risk and suggest investors stay neutral. In addition, we favour quality (upper IG) and less risky debt higher up in the capital structure. Even in HY, we favour subordinated debt from IG issuers. We also think there are attractive opportunities in primary markets, i.e., financials in Europe, but investors should be selective and aware of the liquidity risks. At a sector level, we selectively like financials.

US fixed income

Markets are oscillating between the narratives of a decelerating economy and a hawkish Fed, which has managed to restore some credibility with respect to dealing with inflation. On the other hand, financial conditions have eased despite the tightening comments from the Fed. Thus, while we stay neutral on duration, we are very active and tactical in adjusting/upgrading our stance depending on the extent of yield movements. We are also monitoring real yields – after their recent upswing – to evaluate better entry points in TIPS. In credit, agency MBS spreads are back to fair value now, and thus we think investors may consider reducing their spread duration. We maintain selectivity in credit and we are tracking the recent rally in IG and HY, where valuations are now close to their long-term averages. While we are constructive in IG, we are cautious on HY owing to concerns on fundamentals and earnings. Overall, we keep an agile stance amid limited visibility ahead.

EM bonds

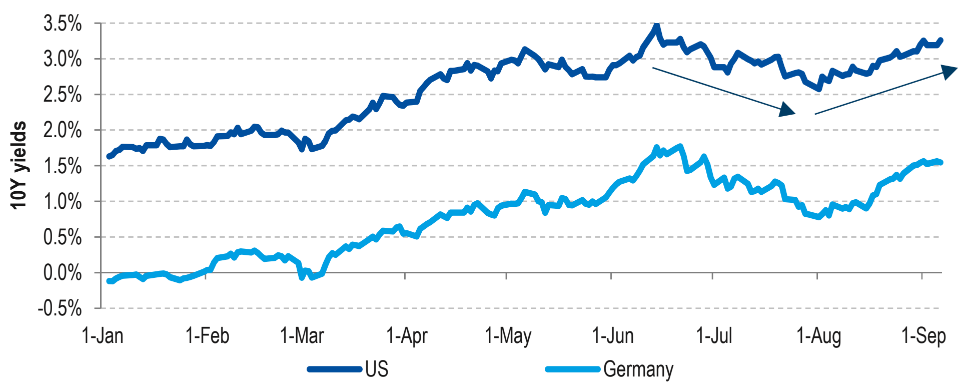
We are cautious on EM duration but acknowledge that monetary policy normalisation in EM is advanced vs. DM, hence there are opportunities in HC (prefer HY to IG). In LC, we are highly selective due to inflation uncertainty and the different tightening pace across countries, but we like high carry countries such as South Africa and Brazil. In China, we are monitoring the growth deceleration, geopolitical risks and government policies.

FX

The evolution of Chinese growth and geopolitical tensions in Europe are creating a complicated environment for FX. While the USD should continue to benefit from global uncertainties in the near term, EUR, GBP, CNH and other cyclical FX are likely to stay depressed. In EM, we like MXN and CLP.

The market's belief in 'higher for longer rates' and their subsequent effect on economic growth is creating opposing pressures on yields, calling for an agile stance

Yields move between hawkish CBs and growth worries



Source: Amundi Institute, Bloomberg, as of 1 September 2022.

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, MBS = mortgage-backed securities, CRE = commercial real estate, QT = quantitative tightening

EQUITY

Quality and earnings resilience in focus

Kasper ELMGREEN,
Head of Equities

Yerlan SYZDYKOV,
Global Head of Emerging Markets

Kenneth J. TAUBES,
CIO of US Investment Management

Overall assessment

High inflation (aggravated by gas/commodity prices) and weak consumer sentiment are affecting real incomes and subsequently discretionary spending. However, markets seem to believe in an ideal scenario where the CBs will be able to control inflation without inflicting a meaningful recession. While we could see some near-term stability in multiples if yields stabilise, earnings will still drive the market's direction in the medium term and this is where some cracks may emerge. **As a result, our priority is to complement stock picking with a quality and value approach to identify companies that reward shareholders.** We believe in the relative resilience of the US and China, but also recognise the geopolitical and economic headwinds faced by the latter.

European equities

We are a bit more selective now as earnings this year and next could be affected in light of the limited forward visibility. In this environment, investors should keep a balanced approach, focusing on attributes such as the pricing power of companies, their individual strengths vs. competitors and product differentiation. We also believe this is the time to prioritise balance sheet strength. At a sector level, we like defensive stocks in staples and defensive industrials. But common factors across our portfolios are how valuations correspond with the earnings capacity of a business and what's the quality of those earnings. On the other hand, we raised our cautious stance on information technology and remain defensive on energy. Overall, we believe investors should stick to fundamentals and look beyond the near term.

US equities

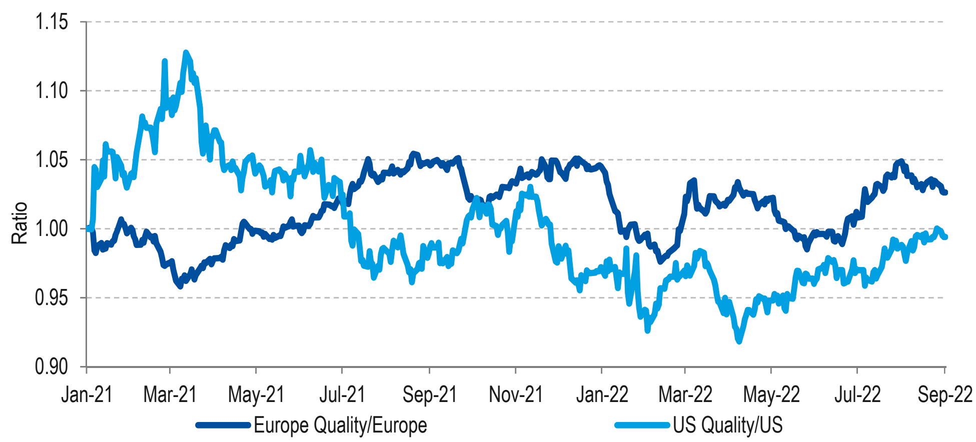
The Fed has clearly indicated its resolve to control inflation, even if this means putting the brakes on the economy. On the other hand, earnings estimates still look too optimistic and will be revised down, though not soon enough because usually such revisions are not good at predicting a slowdown. **We think in this environment investors should maintain a focus on earnings and valuations.** On the latter, we observe that the traditional defensive sectors are expensive and offer little value with respect to long-term returns. We do not like such overvalued stocks and the ones in unprofitable growth. In general, we are focusing on companies with resilient operations and a strong track record of rewarding shareholders through dividends/share repurchases even during a recession. However, cyclicals, which are typically affected by a decelerating economy, have been battered. This is true particularly in the more quality-oriented areas of the market, which now look attractive. These valuations are a source of a major internal debate as we evaluate the extent of the recessionary impact by staying patient and selective.

EM equities

We are cautious on EM amid geopolitical risks (China/Taiwan/US), the current macro tightening cycle and the continuation of the war in Ukraine. However, attractive valuations and large divergences persist. Our main sector convictions are discretionary and real estate, plus a preference for energy. We favour countries such as Brazil and UAE at a time when we are slightly less positive on China due to near-term uncertainties. Finally, we increase our confidence on value over growth.

This has been a year of multiples derating in anticipation of the slowdown, which is reflected in weak leading indicators. Thus, we stay selective and are prioritising balance sheet strength

Quality stocks performance vs. markets



Source: Amundi Institute, Bloomberg, as of 1 September 2022. Europe = MSCI Europe Quality and MSCI Europe. US = Russell 2000 Quality Factor and S&P 500.

THEMATIC GLOBAL VIEWS

Rational inattention at the core of central bank strategy

The origins of inflation are not always well understood. While some economists had warned of impending inflation as early as last year, few had anticipated the dramatic shift in spending from services to goods and the effects of such a shift. The fact that inflation expectations remain subdued is likely due to rational inattention. In the absence of monetary tightening, we believe that inflation expectations would inevitably get de-anchored.

Didier BOROWSKI,
Head of Macro Policy Research

The persistent mismatch between demand and supply will lead to more persistent, widespread and higher inflation than was anticipated until the spring

The return of inflation has become the central economic issue. Public policies and financial markets depend on its level and expected trend.

Yet its origin is not always well understood. The most striking fact since the beginning of the year is the forecasting error made by professional economists. In recent months, they have repeatedly revised their inflation forecasts upwards and their economic growth forecasts downwards, first for 2022 and more recently for 2023.

While some economists had warned of impending inflation as early as last year, few had anticipated the dramatic shift in spending from services to goods and the effects of such a shift in an economy where labour shortages in some sectors have led to persistent supply constraints. Recall that in the spring of 2021 the Fed was forecasting peak inflation at 2.4% and that in Europe inflation was not even a concern last autumn.

The combination of supply and demand shocks since the Covid-19 crisis, as well as policy mixes put in place, have rendered econometric models inoperative. The experience of stagflation in the 1970s had already led to a reconsideration of some of the assumptions used in the models at that time. Robert Lucas' critique (1976) suggests that the use of parameters based on past experience does not allow for an assessment of the effects of changes in macroeconomic policies. If these policies are changed, then the way in which expectations are formed may change, so that the forecast made using a model calibrated with different policies is inaccurate.

The relative importance of aggregate demand and supply shocks differs across countries. In the recent period, aggregate demand factors have played a more important role in explaining US inflation, while negative supply shocks – supply bottlenecks and energy price shocks – have tended to play a dominant role in Europe, at least up to now. In Europe, one of the first sources of forecasting error was the trend of energy prices, especially natural gas prices, which is an exogenous (unpredictable) factor for economists. Initially, the price increase was therefore seen as a temporary supply shock that would dissipate as energy prices stabilised and supply chains normalised. As wages were not indexed to inflation, there was no fear of a self-sustaining inflationary mechanism at the beginning of the year.

Energy prices are the trees that hides the forest. While increased consumer spending has brought production back to pre-pandemic levels, this rebound has coincided with supply chain problems. The result has been a **persistent mismatch between demand and supply, which ultimately leads to more persistent, widespread, and higher inflation than was anticipated until the spring.** As the months went by, it became increasingly clear that demand factors were predominant in the US, where inflation had already started to materialise last year, with a very tight labour market and wage increases. Excess demand was largely due to the expansionary policy mix during the Covid-19 crisis. The US case should have been a wake-up call earlier.

Against this backdrop, it is striking to observe that the major central banks are paying sustained attention to the concept of **rational inattention**[1], explicitly put forward by Jerome Powell at Jackson Hole. This concept allows us to understand how real inflation influences (or not) expectations.

In a nutshell, rational inattention is explained by the fact that economic agents have a limited capacity to understand interactions between economic variables. Their expectations evolve only gradually and insufficiently due to uncertainty about upward signals. In other words, inflation expectations are a lagging variable!

Economic models have been enriched over the last 10 years by taking into account this inertia of expectations. This literature is taken into account by central banks. Less accommodative monetary conditions (real rates are still very negative) are necessary to anchor long-term inflation expectations, even at the cost of a recession.

Finalised on 31 August 2022

[1] *The ECB devoted a working paper to a review of the literature on this subject in June 2021.*

THIS MONTH'S TOPIC

Éric MIJOT
Head of Developed markets Strategy Research

Joao TONIATO,
Senior Equity Research Strategist

'Low quality' results: US Q2 year-on-year earnings growth turns negative if we exclude the energy sector

Q2 earnings season – strong results helped support the summer rally

The Q2 earnings season was again stronger than expected and contributed to the equity market rally up to mid-August. However, the results are of 'low quality' and are not a reason to turn bullish on equities. Ultimately, margins coming down from very high levels should drive the earnings downturn in our view.

The earnings season was positive once again; Q2 YoY earnings growth was +8.5% in the US on the S&P 500, and +29.8% in Europe on the Stoxx 600, based on Refinitiv figures as of 30 August. These are lower numbers than in Q1 (+11.4% in the United States and +42.1% in Europe), but are still excellent results and ahead of consensus expectations. As a first remark, it is worth noting that figures are stronger in Europe than the US, which has to be understood as Europe lagging the United States in the economic slowdown rather than being more resilient to it.

While inflation (and currency weakness in Europe) will continue to support top lines and consequently (nominal) earnings, margins coming down from very high levels will drive the earnings downturn in our view. That, in turn, means that while the current rally could have legs, ultimately, before turning more bullish on equities we would need to see a capitulation in earnings, together with a credible pivot by the Fed.

Beneath the surface, signs of weakness are already visible

Q2 results have been robust across regions. Although European earnings forecasts have been continuously upgraded since the start of the year, 60% of companies in Europe still reported quarterly results ahead of expectations. In the United States, 78% of companies reported results ahead of consensus after earnings forecasts were downgraded in the run-up to the reporting season.

When looking beneath the surface, however, the data gives pause for thought. The Energy sector has been the main driver of results: in the United States, when excluding the Energy sector, Q2 YoY growth numbers turn negative for the first time in this cycle (to -2.2% from +8.5%). In Europe, while the growth number remains positive, it drops drastically to +9.0% from +29.8%.

Moreover, the results are being driven by the top line. Inflation is supporting sales and earnings (nominal) growth. However, below the top line, a trend of margin compression is already clear. Both United States and European net profit margins peaked in Q1, based on Datastream data. Those levels were extreme, with all-time high margins in the United States and the second largest margin ever in Europe (just marginally below the pre-Global Financial Crisis (GFC) peak). Net margins have retraced down from over 12.0% in the United States and over 9.0% in Europe to 10.8% in the United States and 8.3% in Europe, respectively. However, those are still very high levels and further downside is to be expected as pressure on disposable income should intensify and economic activity slows.

Finally, in the case of Europe, the euro's weakness is another key 'low-quality driver' of sales and earnings growth. A c. 10% move in the trade-weighted euro tends to lead to a c. 6% move in EPS. So far, the currency points to a boost of c. 3% to European earnings in 2022..

Finally, beyond these figures, which reflect the past, companies have been getting gradually more cautious in their guidance for the remainder of the year and for 2023. All in all, this implies that the next few quarters will be more challenging and we should not extrapolate the current results as an indication of what the next quarters will look like.

Our view remains that an earnings downturn is ahead of us

The resilience up to this point is not unexpected, even if greater than initial estimates. Despite inflation (and euro weakness in the case of Europe) as pillars of support for revenue growth, margins coming down from very high levels should drive the earnings downturn. Going forward, we may still see some resilience in Q3 results later this year, only less so than in Q2, but the odds are for 2023 earnings growth to turn negative.

The persistent climb up in IBES consensus forecasts for 2022 earnings is now showing signs of waning. Over summer, we saw the first downward revisions for the MSCI World AC FY22 EPS, but the forecast remains at a robust +10.9%. 2022 earnings growth forecasts are now pointing to +7.9% in the United States and +17.1% in Europe. Regionally, downward drivers were the Pacific ex -Japan region (FY22 earnings downgraded by -1.2%) and the United States (-0.6% from last month). However, Japanese earnings were still upgraded by +0.7% and European earnings by +1.8% on the same period. By sectors, as pointed out above, the main contribution comes from continued upgrades in Energy, which is part of the explanation of European earnings being revised up, given the greater weight of the Energy sector in Europe (6.1% of market capitalisation) when compared to US (2.5%).

THIS MONTH'S TOPIC

Margins compression has started: margins have peaked in the United States and in Europe, but levels remain very high

Consumer Discretionary is the main sector seeing downgrades so far, both in the United States and Europe.

Looking at history, 2.0% GDP growth is usually needed for EPS growth to be positive in the United States. Our economists have recently downgraded their forecast to +1.0% from +1.5%, which should translate into a negative figure for US EPS growth next year. By the same token, 3.0% global GDP growth is normally the threshold for European earnings to be positive. Our economists have just revised their forecast to +2.7% from +3.1%. The odds are then for Europe also to deliver negative earnings growth next year.To be clear, in a high-inflation world, an earnings downturn should not be dramatic. The level of decline of earnings in recent recessions, such as 2008 (when US EPS collapsed by some 35% and Europeans by 45%, based on IBES) should not be the base case, but negative prints are due and capitulation is still missing on that front. In the 1970s, a reference for high inflation environment, earnings drawdowns were of the magnitude of -10% in the US. Moreover, in all recessions, at least since the 1970s, European earnings downturns have always been stronger than for the United States.

What is the impact on our equity investment case?

Beyond its apparent resilience, underlying earnings momentum argues for staying cautious on equities.

As the downturn of equity markets this year has been mostly due to a sharp rise of inflation and the late and strong tightening of monetary policy, the market perception of peaking US inflation has led to a retracement when equities were oversold. The resilience of Q2 earnings has just added another argument to support the rally.

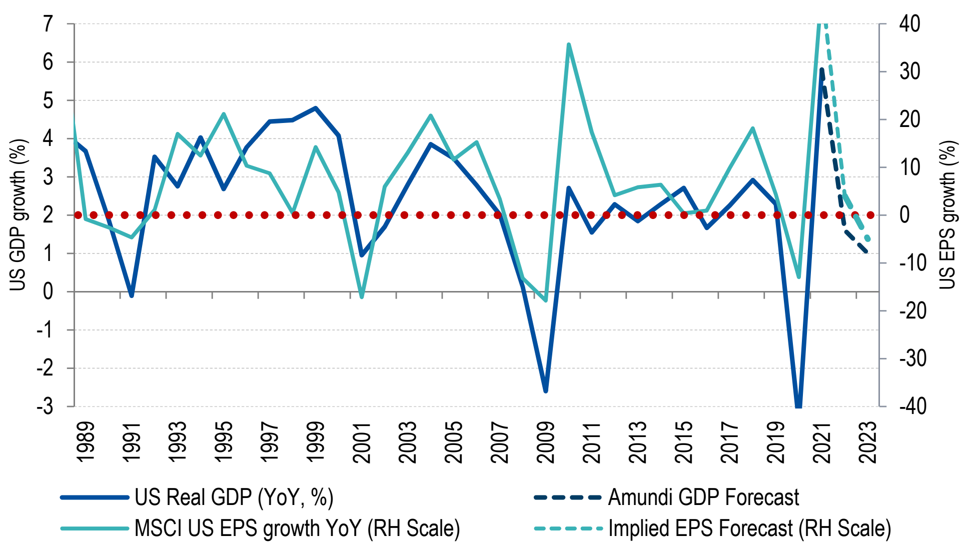
Current US P/E (18.9x trailing earnings) is broadly consistent with inflation falling back below 3%. Based on this assumption, most of the repricing of equities would have been done (in terms of trailing P/Es). If not, a higher inflation regime of 3-6% would argue for a lower P/E with an equilibrium around 16x. On the earnings side, a regression of the S&P 500 to earnings tells us that after its rebound the United States market is anticipating only flattish earnings growth, everything else being equal, and only a small setback in Europe. While this scenario remains a possibility, should inflation fall and the US and global economy stay resilient at the top of the rally, markets seem to be priced for perfection; there is no room for any disappointment.

Adopting a pro-cyclical stance would require a successful pivot by the Fed and a capitulation on the earnings side; these conditions are not yet in place. As a conclusion, the odds are still for this move to stay a countertrend one.

Regionally, we maintain a preference for the United States over the Eurozone. The market focus should eventually shift from 'too much inflation' to 'not enough growth'. Eurozone equities, which are both more cyclical and are lagging the United States in terms of earnings downgrades, should potentially be less resilient than the United States.

By styles, our approach is quite diversified. Combining Value and Quality still makes sense as a core position. Value remains an inflation hedge, should the market forecast be too optimistic on this side, and Quality usually benefits during end cycles, when earnings are in danger. High (and secure) dividends should benefit; when equity returns are low, dividends account for a big portion of them. Finally, Minimum Volatility also makes sense, as volatility tend to rise during end cycles, when earnings revisions are accelerating.

1/ **US GDP Growth & US EPS growth**



Source: Refinitiv, IMF, Amundi Institute. Data as of 31 August 2022

THIS MONTH'S TOPIC

Stocks with earnings/margin resilience remains a key conviction

At the sector level, profit resilience is key.

While defensives have underperformed during the recent market bounce-back and cyclicals remain cheap, we see sustainability of margins/earnings as the key driver of allocation across sectors. This leads us to an overall preference for defensives. In some cases, cyclical sectors can also offer resilient margins and profitability. Therefore, our European sector allocation could be seen as a 'barbell' strategy, but with somewhat more weight on the defensive side.

The Healthcare sector remains key to us but we have highlighted the extreme gaps in valuations between Healthcare Equipment stocks and large Pharma stocks. So, we remain positive on Healthcare, but prefer to play it via Healthcare Equipment names. Staples remain a key preference despite high valuations, Personal Products and even Food & Beverages stocks continued to outperform throughout the rally, even after outperforming up to the rally. This should continue as those stocks should show resilience against the earnings downturn.

Across non-defensive sectors, we believe Energy might have further upside, especially if the economic downturn proves mild. High Quality areas such as Luxury Goods are a key overweight in our view as a sector where profitability and margins are very resilient. Construction offers opportunities, especially for stocks exposed to fiscal stimulus and government investments, which should protect profits through the downturn. Equally, Aerospace & Defence should have a long-term structural tailwind behind its profits going forward.

While Financials could buck the trend of margin compression, due to higher rates supporting margins, we maintain a preference to play it via Insurance stocks, given the higher risk of Banks in an economic contraction.

Finally, as for sectors to avoid, Mining was a key underweight for us in recent months, given the turn in metal prices and its large dependence on the Chinese market at a time when lockdowns are impacting activity, and the outperformance earlier in the year appeared overdone. The sector has underperformed sharply since June, so we have reduced some of the underweight but remain cautious. We continue to avoid Real Estate as a key underperformer in economic downturns, especially when inflation is high. Technology is a sector we have avoided and are not ready to move back into yet until we see more clarity on a path back towards lower inflation.

Finalised on 31 August 2022

THEMATIC

Taiwan: depicting the unthinkable

Russia's recent invasion of Ukraine has focused investors' minds on the Taiwan issue and the People's Republic of China's potential approach to it. We believe that the risk of war remains low.

Patrice LEMONNIER
Head of EM Equity

Nick MC CONWAY
Head of Asia ex-Japan Equity

The People's Republic of China sees Taiwan as an integral part of its territory. This stance was shared by the Western allies post-WW2 and confirmed by the general global acceptance of the one-China policy over the last 40 years. Hence, it is reasonable to assume that the PRC would like at some point to reunite the governance of Taiwan under Beijing. Xi Jinping himself said in January 2019 that the political division across the Strait "cannot be passed on from generation to generation". Some observers believe – rightly or wrongly – that the Chinese leader wants to resolve the Taiwanese issue before his rule ends.

This reunification of China nevertheless poses a significant challenge, given that over the years, Taiwan's governance has evolved to a democratic process. A full integration has been rendered even more complicated by China's handling of Hong Kong's integration, which has not been well perceived by Taiwanese people.

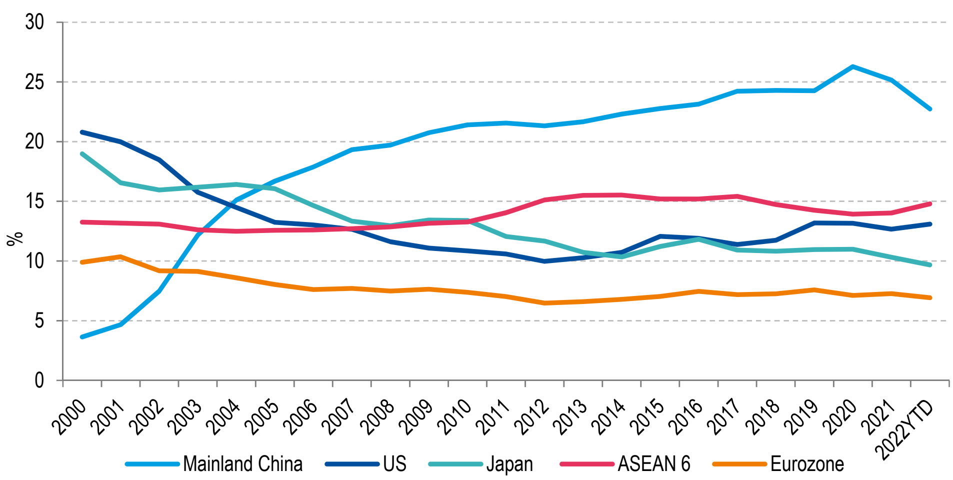
Past statements by Xi Jinping, the growing animosity between US and China, and Russia's recent invasion of Ukraine have focused investors' minds on the Taiwan issue and the People's Republic of China's potential approach to it. The recent visit by Ms Nancy Pelosi was considered by China as a provocation, considering this was a breach of the one-China policy, something the US had formally acknowledged. Fortunately, President Biden apparently made it clear during a 137-minute call with President Xi Jinping on 28 July that he did not approve of the visit and that Washington's policy towards Taiwan remains unchanged.

We believe that the risk of war in Taiwan remains low, not only for the above reasons but also because:

- The economic cost to both China and the developed world would be catastrophic. It would likely bring Europe closer to the US on a global containment strategy, likely triggering co-ordinated sanctions that would lead to a global economic crisis. The Chinese economy would take an immediate direct hit, due to collapse of export demand and production disruptions. For the rest of the world, it would prove to be a huge supply shock of a magnitude much greater than the Ukraine war, pulling down global potential growth. A war would seriously affect as well China's long-term growth prospects; access to inputs where it is not self-sufficient (such as primary materials and high-tech components for semiconductors) would likely become more difficult, as it would probably lead to a full separation of the Chinese economy from the West.
- Clearly, China's impressive economic progress over the past 30 years, which has lifted hundreds of millions of people out of poverty to first-world income levels, has been crucially instrumental in the Chinese people's support of the current regime. In our view, a setback would severely weaken the mandate given by the population, and the nationalist rhetoric will likely do little to make up for a collapse of the standard of living.
- Some military experts believe that China's military resources are not sufficient to

A war would seriously affect as well China's long-term growth prospects

1/ **Taiwan's trade with major partners, as a share of total foreign trade**



Source: Amundi Institute, CEIC. Data as of August 2022

THEMATIC

The importance of sustainable and high-quality Chinese growth and increasing prosperity has never been more important to the PRC

successfully operate landings further than 140 km off its shores (as was the case in Normandy during World War II):

- A war with Taiwan would not result in an appropriation of Taiwanese technology, as material and human expertise would most probably evaporate. More likely, semiconductor factories would be (voluntarily or not) damaged and key people would flee overseas.
- The willingness displayed by Western countries to sanction Russia on every level (individuals, corporates, and FX reserves) is probably a strong deterrent for Chinese authorities, who can only expect a similarly harsh reaction to a Taiwanese invasion.

We would also assign a low probability to an outright blockade of Taiwan. The main reason is not that it would disrupt traffic in the Taiwan Strait, the world's busiest container-shipping route, used by 88% of the world's largest ships, as other routes could be used (even though alternatives are significantly longer and hence much more costly). Our low expectation of a long-lasting blockade of Taiwan is based on the premise that the island is a key part of the global semiconductor supply chain. A blockade would inflict strong economic damages to both China and the West, and hence to the global economy.

However, while we believe there is a low probability from both China and US to willingly start a war, we also think that the risks of potential accidents have risen, as:

- The US is committed to a higher level engagement with Taiwan (ideologically speaking: the democratic world against autocracy, especially after what has happened between Russia and Ukraine);
- Xi's China is more and more frustrated by the fact that the one-China policy is being interpreted differently by US and its allies;
- The regular communication between China's PLA and the US military was suspended after Pelosi's visit.

We believe that the importance of sustainable and high-quality Chinese growth and increasing prosperity has never been more important to the PRC. Indeed, notwithstanding Xi's recent nationalist comments, there is no ticking clock. It is also true that, notwithstanding the recent more authoritarian direction of the Chinese Communist Party, a regime change or political transformation is not completely inconceivable, given what happened in South Korea, Brazil, Greece,... and Taiwan.

Latest news: the Chinese military said on 10 August that it had completed its exercises around Taiwan but would regularly conduct patrols and drills in the area.

Finalised on 22 August 2022

THEMATIC

LatAm elections cycles wrapping up: politics and policy transitions in full swing of uncertainty

Patryk DROZDZIK
Senior EM Macro Strategist

LatAm's dramatic elections calendar landed three leftist presidents in the Andean region

LatAm's dramatic elections calendar that landed three leftist presidents in the Andean region might be two-thirds over, but the political and policy uncertainty created by these election results is far from it. Chile and Colombia are expanding the size and role of the state, while intense political and macro conditions have forced yet another and a big-time government reshuffle in Peru and Argentina, respectively. In Brazil, which has yet to hold elections, Lula leads Bolsonaro comfortably, but the gap has been narrowing there as well.

It has been an eventful, if not dramatic, political cycle in Latin America, driven by anti-establishment sentiment and public discontent with the status quo, magnified by the economic and health flaws exposed by the Covid-19 crisis. The cycle kicked off a little over a year ago, when Peru elected a (hard) leftist president, followed six months later by a similar outcome in Chile. Then Colombia, and only recently, made it three for three in the Andean region when it comes to left-wing heads of state. This was an even more surprising result there given the country's political history – it had never elected a leftist president before. But there were also a couple of (mid-term) election results that defied the general trend. Both in Argentina and Mexico, ruling coalitions lost important seats that meant relinquishing a simple majority in the case of Peronists and a qualified majority for Andrés Manuel Lopez Obrador's party Morena.

While the election season is two-thirds, the political and policy uncertainty results is far from over. In **Argentina,** a government reshuffle in a more orthodox direction was needed to arrest a run on the peso and a disorderly economic adjustment that would have undermined further the Peronists' chance in next year's elections. In **Peru,** another reshuffle – there has been on average one ministerial change every several days – was needed to address deep and chronic governability issues under president Pedro Castillo and impeachment is the most likely outcome. **Chile's** focus shifted to the constitutional process that will decide if the newly drafted constitution will be implemented or the process restarted. In addition, Gabriel Boric's administration is advancing an ambitious tax reform and will unveil soon its proposal for a pension reform with significant implications on the economy and society. In **Colombia,** the electoral transition has been smooth, though the far-reaching tax reform suggests that the administration is full of ambitious proposals in line with the campaign promises.

Brazil will hold elections in October. Former president Luiz Inacio Lula da Silva leads the incumbent Jair Bolsonaro comfortably, though the polls are showing narrowing dynamics, aided by slowing inflation and boosted by direct transfers. Changes to macro policy are on their way, though they will pale in comparison to the rest of the region, with the exception of **Mexico,** a relative oasis of political peace in LatAm. Where domestic politics is less of a headwind, frictions on the USMCA free-trade agreement front are worth keeping an eye on as they could undermine otherwise big-time tailwinds, courtesy of the recent geopolitical shocks.

Below we discuss in more detail country-specific developments of political and policy nature

Colombia: Gustavo Petro's third time is a charm. A smooth electoral transition and meaningful macroeconomic changes are under way

In June, Petro won the second round of presidential elections against Rodolfo Hernández (a right-wing independent) 50-47%, becoming Colombia's first ever leftist head of state. The third time was a charm – Gustavo had already run in 2010 and reached the run-off in 2018 – and he became the Andean's region third left-wing president in this election cycle.

Petro ran on a ambitious leftist platform that included a tax, pension, land and healthcare reforms as well as a ban on new oil exploration The latter could be problematic for a country running sizeable twin deficits. He seemed to have moderated his views between the two rounds, named an orthodox finance minister (José Antonio Ocampo), as Boric did in Chile, and formed (a conditional) working majority in Congress that should avoid Peru-like governability pitfalls. While showing signs of moderation, the recently unveiled tax reform highlighted what the new administration is about – a bigger role for the state, heavier spending via taxation of the rich, corporates and extractive industries, the latter to lean on its size as well – with the ultimate goal of reducing the country's economic inequality.

We have yet to hear how the additional revenues will be spent, but we suspect a much larger portion will be redistributed rather than saved. While oil windfalls and an overheated economy have stabilised cyclical debt dynamics, Colombia needs a structural plan and a working fiscal rule to keep public liabilities on a sustainable trajectory.

THEMATIC

The newly drafted constitution was rejected by a great majority of Chileans even tough an even greater portion of the society sees the old Pinochet-era Magna Carta as outdated

Chile: the rejection win in the constitutional exit referendum will restart the process in a more constructive environment

The newly drafted constitution was rejected in September 4 exit referendum in an ambiguous way - 62% to 38% in favour of reject. The process will continue however given majority sees the old Pinochet-era law of the land as outdated and to prevent a new round of social unrest resembling the events of late 2019.

President Boric is in favour of redrafting Chile's Magna Carta from scratch (with a more representative constitutional assembly), while the opposition would like to do that via amendments with Congress, already lowering the constitutional majorities needed to pass potential amendments. Whichever path is taken, the next constitution is likely to be of better quality than the one just drafted. That suggests the peak in uncertainty, when it comes to tail risks, is already here though uncertainty will linger for longer.

The government is also working on an ambitious tax reform to raise an additional 4% of GDP in revenues, much of which would be spent on various social programmes. There is also a pension reform to be unveiled that will put further pressure on public coffers. All in all, while under the pragmatic stewardship of finance minister Mario Marcel, the economy is undergoing significant shifts as the size of the state grows and its role changes from a regulator to a provider of services.

Peru: another government reshuffle will not improve governability sustainably and only delays an eventual impeachment

Pedro Castillo's government sees on average a fresh ministerial nomination every several days – there have been nearly 70 reappointments since the new administration took over in summer 2021. The latest reshuffle a few weeks ago included six ministries, though the prime minister's resignation was not accepted by the president. The important finance and economy portfolio was handed to Kurt Burneo, a former minister, central bank board member and a politician with more political clout than his predecessor. The other appointments were more questionable and included people previously relieved of their duties, e.g., Chavez. Both the rejection of Anibal Torres' resignation and subpar appointments to other posts suggest Castillo struggled to recruit 'serious' individuals to join his cabinet.

The reshuffle will protract the current suboptimal status quo, where governability is

President/ Country	Elected	Appetite to rewrite constitution?	Orthodox finance minister?	Supports redistributive policies?	Supports CB independence?	Against extractive industries?	Other	Checks & balances/ governability
Gustavo Petro Colombia	June 2022	No	Ocampo, Yes	Yes! Ambitious tax reform unveiled	Yes, but?	Wanted to halt new exploration, now tax it heavily	Wants pension reform + trade protectionist	Conditional working majority
Gabriel Boric Chile	Dec. 2021	Yes, underway	Marcel, Yes	Yes, big tax reform coming	Yes	Wants to tax it heavily	Pension reform a must	Balanced Congress
Pedro Castillo Peru	June 2021	Yes but no votes	Burneo, Yes	Not exactly	Yes	Yes	Trade protectionist	Very fragmented = governability a major issue
Andrés Manuel López Obrador Mexico	July 2018	No, energy sector only	**Biggest fiscal hawk!**	Via aggressive minimum wage hikes	Yes	State-centric approach		Lost qualified majority in mid-term elections
Jair Bolsonaro Brazil	Oct. 2019	No	Guedes, Yes	No	Yes	No	Passed a prudent pension reform	Working majority
Luiz Inácio Lula da Silva Brazil first Lula presidency	Oct. 2002	No	Not really	Yes	No	No	Trade protectionist	Strong Partido dos Trabalhadores and presidency
Alberto Fernández Argentina	Dec. 2019	No	Now Massa, relatively speaking	Yes	No	No	Trade protectionist, capital controls	Balanced now after losing majority

Traffic light system: Good Warning sign Bad

THEMATIC

The unbalanced economy of Argentina desperately needs an orthodox policy response

Both candidates want to adjust the spending cap and make permanent the recently passed measures of a temporary nature and reshape the tax system, though in a different shape and form

a big issue. Unlike in Colombia, or especially Chile, big time structural/regime changes are less likely, given the lack of consensus on just about anything (including impeaching the current president). Lack of governability is a cyclical headwind, but less of a structural impediment requiring significant market repricing.

The current situation seems unsustainable and will end, we suspect, in an impeachment, also because the sitting president does not want to resign as that would further expose him legally. The opposition is rumoured to be just several votes short of the necessary 87 to get rid of Castillo and is reluctant to pull the trigger on a move that would cost the current congressmen their jobs. An impeachment in Peru also leads to a dissolution of Congress and fresh elections, in which current congressmen cannot participate. As the present erratic situation is unsustainable, we suspect an impeachment will eventually take place.

While new elections would raise political uncertainty in the short term, they are likely to be a step in the right direction, towards a more orderly functioning political ecosystem that would serve the country more constructively in the medium term.

Argentina: a necessary reshuffle to arrest the run on the peso. Addressing the underlying problems is a likely post-election story

The unravelling FX situation in the aftermath of finance minister Martin Guzman's resignation eventually led to a political reshuffle in August and the appointment of Sergio Massa as a 'super minister'. He will head the ministry of the economy, production, and agriculture and be in charge of talking to the IMF. Massa, a former chief of staff, presidential candidate, and until recently, the lower house speaker, is considered to be one of the most market-friendly politicians within the ruling coalition and one with a significant political clout. In line with the latter, Massa named a well-trained economist Gabriel Rubinstein as his number two, who is also known for being a fierce critique of the vice president and her policies. This suggests Massa has been given the freedom to implement policies needed to stabilise the economy though at a minimal political cost.

The unbalanced economy desperately needs an orthodox policy response. Massa's appointment is a much-needed confidence boost that should lead to an improvement in governability and to a reduction in political uncertainty. He will focus on reaching the IMF deal targets, such as closing the primary budget deficit around 2.5% of GDP, reducing monetary financing and tightening monetary policy, e.g., bringing real rates into positive territory – the central bank has been hiking rates aggressively, though hi-flationary price dynamics have nullified much of its progress. When it comes to fiscal adjustment, Massa will hike public utility tariffs and cut energy subsidies in a segmented way, especially to high earners, while tariffs for the low-income population will remain unchanged, and will introduce consumption caps. In addition, public capex and transfers to provinces will be cut, though social assistance programmes will probably rise, not fall.

While Massa's actions are likely to stabilise the macroeconomic tailspin and the near-term IMF review(s) are likely to pass, in light of next year's elections, the administration is unlikely to go for what is needed to resolve the underlying economic imbalances, e.g., currency devaluation. In fact, spending and populist pressures are likely to grow as the elections near, implying, in turn, that the macroeconomic starting points will deteriorate by the time the next administration is in place to tackle them.

Brazil: it is election time, but risks seem less pronounced than in the rest of South America

The presidential race is fully on with the first round of general elections scheduled for 2 October. Former president Lula is leading the incumbent Bolsonaro by a comfortable 10% (45% to 35% when averaging across the polls, which diverge widely), though the lead has been narrowing. We suspect the gap will close further, helped by media campaigns, debates, slowing inflation (now back in high single digits), fuel price cuts, and boosted direct transfers (e.g., Auxillio Brasil payments were raised to $R600/month).

While the race is tightening, the markets seem relaxed, though not indifferent, to the two most likely outcomes. On the one hand, the leftist Lula is talking the prudent populist talk and already with a centrist vice president name on his presidential ticket. On the other, the current economy minister Paulo Guedes confirmed he would stay on, were Bolsonaro to win the re-election. Finally, a likely centrist Congress is expected to play a moderating role when it comes to policy actions.

Changes are coming regardless of who is in charge on 1 January 2023. Both candidates want to adjust the spending cap – the country's ultimate fiscal anchor – and make permanent the recently passed measures of a temporary nature and reshape the tax system, though in a different shape and form. On a more positive note, they also see the need to pass structural reforms such as an administrative reform. All these will have an impact on potential growth, short- and long-term revenues, spending and fiscal paths and, in turn, on inflation expectations and asset prices.

Mexico: relatively benign domestic politics overshadowed by USMCA frictions

Since losing the qualified majority in 2021 mid-term elections, the Morena coalition has attempted unsuccessfully to pass a constitutional amendment to reform the country's electricity sector that favoured the state over private participants. In a related

THEMATIC

issue, nor did the Supreme Court rule in favour of the government initiative, though it did not strike down the proposal altogether. It seems it will be the actions of the international actors, not the domestic ones that pose a hurdle for the AMLO administration within the energy space. USMCA trading partners have launched an official dispute over violation of the trade treaty that will soon progress to a much formal and long-lasting stage of panel negotiations.

While the state-centric energy sector is AMLO's priority, we suspect USMCA is no less important to him for economic reasons. We expect some sort of middle-ground solution will be reached under which a more 'flexible' projects and permits-award system will be in place, while the key elements of AMLO's underlying policies will not change. That would alleviate the risks of a USMCA break up and give the country a strong platform to benefit from meaningful nearshoring trends in light of recent geopolitical events.

Finalised on 30 August 2022

CENTRAL & ALTERNATIVE SCENARIOS (12 TO 18 MONTHS HORIZON)

Monthly update

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

DOWNSIDE SCENARIO 15%

Deep global slump

Analysis

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

Market implications

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

CENTRAL SCENARIO 70%

A stagflationary episode, with rising divergences

Analysis

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

Market implications

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

UPSIDE SCENARIO 15%

Inflation falls back quickly, ending the stagflationary episode

Analysis

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

Market implications

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

Geopolitic · *Covid-19 related topics* · *Growth and inflation expectations* · *Monetary and fiscal policy* · *Recovery plans or financial conditions* · *Solvency of private and public issuers* · *Economic or financial regime* · *Social or climate related topics*

TOP RISKS

Monthly update

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

ECONOMIC RISK 30%

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

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

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

FINANCIAL RISK 30%

- **Sovereign debt crisis**
  - An extended war in Ukraine would hurt DM vulnerable public finance with public debt ratios already at historically high levels
  - De-anchoring inflation expectations could lead to harsher monetary tightening and a bond market dislocation
  - Most countries are vulnerable to rating downgrades and rising interest rates
  - EM weaknesses could also face a balance-of-payments crisis and increased default risks
- **Corporate solvency risk increases,** amid deteriorating fundamentals, rising uncertainty and corporate margins under pressure (high input cost, double orders lead to profit warnings)
- **Widespread greenwashing and ESG investment bubble** undermine the energy transition funding
- **USD instability** and gradual loss of its reserve currency status lead to unstable currency markets
- **Currency wars:** currency appreciation is a way for CBs to fight inflationary pressures

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

\- Oil, risky assets, frontier markets and EMs

(GEO)POLITICAL RISK 30%

- **War in Ukraine**
  - Prolonged military struggle leading to high intensity conflict and potentially to a western military confrontation
  - High risk of accident at nuclear facilities in Ukraine
  - [That said, it is possible that in the coming months the situation will calm down, paving the way for a resolution/cease-fire]
- **EU political fragmentation** or populist vote bring a disagreement on how to manage the relationship with Russia
- **The US takes a hard line with China** in order to block any tentative to invade Taiwan. Risk of accidental confrontations in the South China Sea or the Taiwan Strait
- **EM political instability driven by** higher food and energy prices, leading to a wave of unrest
- Iran or Korea **nuclear programs** renewed concerns and sanctions
- **US & China lose credibility** on the energy transition and undermine the Paris agreement
- **Global warming** leads to an increased risk of conflicts, driven by water shortages and migratory movements
- **Cyber-attack or data compromise,** disrupting IT systems in security, energy and health services

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

\- Credit & equity, EMBI

CROSS ASSET DISPATCH: Detecting markets turning points

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

ECONOMIC BACKDROP

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

FUNDAMENTALS & VALUATION

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

NEUTRAL + ASSET ALLOCATION

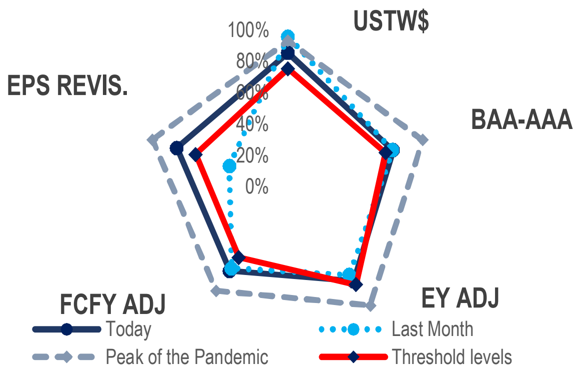
TECHNICALS

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

SENTIMENT

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

Cross Asset Sentinels Thresholds (CAST) still supportive



Source: Amundi Institute, Data as of 26 August 2022

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

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

GLOBAL RESEARCH CLIPS

1 US macro forecasts revision: ongoing growth deceleration

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

Investment consequences

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

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

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

Investment consequences

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

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

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

Investment consequences

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

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

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

Investment consequences

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

GLOBAL RESEARCH CLIPS

5 China: factor in a greater housing slowdown

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

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

Housing: too late and too reserved

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

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

Investment consequences

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

Covid-19 situation update

Francesca PANELLI, *Investment Insights and Client Division*

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

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

IMPORTANT INFORMATION

Date of first use: 12 September 2022

Document issued by Amundi Asset Management, "société par actions simplifiée"- SAS with a capital of €1,143,615,555 - Portfolio manager regulated by the AMF under number GP04000036 – Head office: 90-93 boulevard Pasteur – 75015 Paris – France – 437 574 452 RCS Paris – www.amundi.com

Photo credit: ©MDelporte - iStock/Getty Images Plus - Stephen Simpson

Chief editor

BLANQUÉ Pascal, *Chairman of Amundi Institute*

Editor

DEFEND Monica, *Head of Amundi Institute*

Deputy-Editors

BOROWSKI Didier, *Head of Macro Policy Research*
PANELLI Francesca, *Investment Insights and Client Division Specialist*
PERRIER Tristan, *Macroeconomist and Investment Insights Specialist*

Amundi Institute contributors

AINOUZ Valentine, *Deputy Head of Developed Markets Strategy Research, CFA*
BERARDI Alessia, *Head of Emerging Macro and Strategy Research*
BERTONCINI Sergio, *Senior Fixed Income Research Strategist*
BOROWSKI Didier, *Head of Macro Policy Research*
CESARINI Federico, *Head of DM FX, Cross Asset Research Strategist*
DI SILVIO Silvia, *Cross Asset Research Macro Strategist*
DROZDZIK Patryk, *Senior EM Macro Strategist*
GEORGES Delphine, *Senior Fixed Income Research Strategist*
HERVÉ Karine, *Senior EM Macro Strategist*
HUANG Claire, *Senior EM Macro Strategist*
MIJOT Éric, *Head of Developed markets Strategy Research*
PANELLI Francesca, *Investment Insights and Client Division Specialist*
PORTELLI Lorenzo, *Head of Cross Asset Research*
TONIATO Joao, *Senior Equity Research Strategist*
USARDI Annalisa, *Cross Asset Research Senior Macro Strategist*
VARTANESYAN Sosi, *Senior Sovereign Analyst*

Amundi Investment Platforms contributors

LEMONNIER Patrice, *Head of EM Equity*
MC CONWAY Nick, *Head of Asia ex-Japan Equity*

With Amundi Investment Insights contribution

BERTINO Claudia, *Head of Amundi Investment Insights & Publishing*
CARULLA Pol, *Investment Insights and Client Division Specialist*
DHINGRA Ujjwal, *Investment Insights and Client Division Specialist*
FIOROT Laura, *Head of Investment Insights & Client Division*

Conception & production

BERGER Pia, *Communication Specialist*
PONCET Benoit, *Communication Specialist*