Research

01
January
2021

CROSS ASSET
Investment Strategy

CIO VIEWS
The big shock, the big hope, the big illusions

THIS MONTH'S TOPIC
2021 global outlook reassessed

Confidence must be earned
Amundi
ASSET MANAGEMENT

#01 - January 2021

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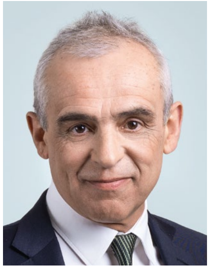

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The big shock, the big hope, the big illusions

2020 has been an unprecedented year in modern history, with the Covid-19 pandemic leading to the deepest global recession post World War II that has affected the most countries simultaneously since the 1870s (World Bank). **This big shock is not going to reverse completely, and the old normal will not return as it used to be.** Hopes for a fast vaccine distribution, a further fiscal push, and for decreasing geopolitical tensions are all driving the reflation narrative. As a result, despite the recession, most markets are closing the year with positive performances. Entering 2021, the reflation phase may continue, but investors will have to assess four factors to play the rotation, avoid bubbles, and build resilient portfolios.

Factor 1. Recent market rally is based on blind faith in the success of vaccines and on the brave assumption that everything will be as before. This is the first source of risk – not only because the production, and dissemination, of vaccines on a large scale is not a trivial endeavour, but also because markets are assuming that a large majority of the population will be vaccinated. The idea of normality being just around the corner is a chimera, and this will bring up all the issues associated with this scattered restart. For investors, distribution of a vaccine should further support recovery and the case for favouring equity vs HY credit. In this rotation, Value will benefit the most while investors should stay cautious in the most crowded growth areas, where a significant bubble could be under pressure in a reflation environment.

Factor 2. Fiscal and monetary policy are keeping the economic system going, but what has been put in place so far is insufficient – especially on the fiscal side – but also not always well directed or calibrated. Any withdrawal of measures is unthinkable; on the contrary, CBs will be called upon to do more, and the risk of a policy mistake is underestimated by the market. On the other hand, some inflation pressure will eventually materialise. At the beginning of 2021, 10Y Treasury yields are now above 1%, the highest level since last March.. Should the recovery drive some higher inflation, yields could rise further, with some possible domino effects on markets. Again, we do not expect to see high inflation tomorrow, but buoyant housing markets, supply chain relocations, and a huge amount of savings waiting to fuel pent-up demand could rapidly change the zero inflation narrative forever. It's likely that the Fed will intervene in case of any quick move in yields in a sort of curve-control mode. Investors should be watchful of inflation to avoid being trapped in the long-duration trade, which is increasingly risky. We recommend a balanced approach to duration and investors should consider exposure to US inflation which could be first to materialise in a weak dollar scenario.

Factor 3. The recovery path is being led by China. It is leading the way out of the crisis as the only big economy to fully recover in 2020. In 2021, China should continue on this trajectory of faster growth compared to the RoW, lifting EM Asia and with a positive feedback loop, especially with Europe, given the strong trade links with China and Asia. Investors should consider entering 2021 with an allocation to EM, and Chinese and Asian equities. In fact, despite the strong performance seen in 2020, there is room for further growth, in our view, especially in areas more linked to internal demand.

Factor 4. The key risk today in the market is the consensus itself. The skyrocketing negative-yielding debt will push the search for yield to the extreme. The temptation to go down in quality is high as well as to make all the same low-interest-rate forever bets. But, this is dangerous, if we consider the scarce market liquidity in the system. For investors, credit selection is paramount, but it is key to look across the board to search for yield. Including investments in private markets, for investors with the appropriate time horizon, will provide a wider and diversified spectrum of opportunities. In addition, investors should balance the appetite for yield in HY and EM bonds (including LC) and credit with exposure to government bonds as liquidity providers and diversifiers in asset allocation.

Investors will enter 2021 with a positive backdrop for equities. Lower expected returns in bonds amid low interest rates and tight credit spreads mean that investors will have to embrace higher risk (higher equity) to reach their return targets. Volatility could also return in 'stop-and-go' phases related to vaccine distribution. This reminds us of the importance of **adding further sources of diversification with uncorrelated investment strategies and keeping some hedges in place.** The outlook is positive, but the road to recovery will likely be bumpy. Fasten your seat belt and watch out for a 2021 full of opportunities.

Overall risk sentiment

Risk off Risk on

Watch out for inflation and selective rotation into equities balanced by the need for hedges and duration exposure

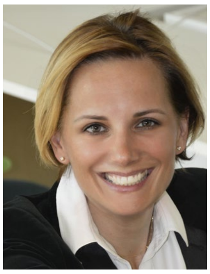
Changes vs. previous month

- Exploit rotation opportunities in cyclical, value segments
- UK assets upgraded (equities and GBP)
- Use TIPS for diversification and inflation protection

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

MACRO

ECB: strong support to Euro fixed income in 2021



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The increased stimulus is consistent with a scenario of low rates for longer and search for yield in the Eurozone

Very much in line with consensus and market expectations, the package delivered by the ECB at its December meeting combined additional measures of quantitative easing (QE) with further support to the financial system. The pandemic programme (PEPP) was extended in time and increased by EUR 500bn while the APP (Asset Purchasing Programme) was confirmed to proceed at the current path of EUR 20bn in purchases per month, meaning additional firepower of EUR 300bn over 15 months. Measures in support of the financial system came through the TLTRO[1] tool, extended, enlarged in its scope and confirmed in terms of very favourable conditions attached to ECB lending operations. A nine-month extension of the PEPP into 1Q22 is longer than the six-month (end 2021) extension generally expected by consensus, but the decision appears to be consistent with recent messages from many ECB members on the importance of both the size and duration of the stimulus. The extension of the reinvestments horizon of maturing bonds is very much in the same direction as well.

The ECB's emphasis has turned mostly on providing and keeping favourable funding conditions for as long as needed to support economic growth in recovering from the pandemic crisis. In the Q&A following the meeting, President Lagarde underlined that the strategy of the ECB aims at *"preserving favourable financing conditions over the pandemic period"*, defining them *"in a very holistic way"*, namely *"for all sectors of the economy."* Therefore, the ECB made it clear that lending rates to households and corporates, and at sovereign levels are all within the scope of the support, together with credit flows to the economy. In order to reach this target, the ECB calibrated a very strong increase in its QE, securing a *"significant constant market presence"* which will provide the central bank with the necessary flexibility for managing its QE. In this respect, the ECB president also underlined the symmetry of the eventual pace of adjustment as on one side, the envelope represents a ceiling and *"does not have to be spent in a pre-defined way, or even in full"*, but *"equally, the envelope can be increased if it is necessary."*

We assess that the increased stimulus looks consistent with the objective of **keeping up support for technicals regarding fixed income markets into 2021** and thus supporting the current low rates for longer scenario as well as the yield search.

Between the now larger PEPP and APP, **the ECB will in fact have more than €1.4tn of remaining net purchasing capacity by end-March 2022**.

ECB QE also looks more than sufficient to cover eventual additional Euro government bond net funding that may be needed to finance new support measures to counteract negative impacts from current restrictions and to increase its presence in supranational segment as well in sight stronger EU issuance. On the TLTRO side as well, our guess is that the **new measures will be effective in keeping a high level of liquidity available in the financial system, indirectly supporting bond technicals.**

Ultra-cheap credit for banks, even with strong conditionality, will not be enough to avoid a tightening in banks' lending conditions for companies. This crisis has been characterised by contra-cyclical credit conditions, thanks to the coordinated actions of CBs and governments.

In recent months, banks' credit conditions have remained accommodative, thanks to (1) strong liquidity injections via TLTROs and (2) government loan guarantees. The massive supply of credit for all businesses has limited corporate defaults and the long-term economic damage from this crisis. **We remain concerned about a significant tightening in bank lending conditions once government guaranteed loans expire.** Banks had already curtailed access to corporate credit in Q3 and expected to tighten further in the coming three months. "Banks referred to the deterioration of the general economic outlook, increased credit risk of borrowers and a lower risk tolerance as relevant factors for the tightening of their credit standards for loans to firms and households".

The duration of the monetary support is as key as the degree of accommodation. A lot of monetary and fiscal support is currently justified by the pandemic. However, very accommodative monetary policy will still be needed after March 2022. In the coming years, (1) inflation is expected to remain well below the 2% target and (2) economic fragmentation among Eurozone countries will continue to be a challenge.

In 2021, questions and concerns will arise about what kind of monetary support is required once the coronavirus crisis ends. It is likely that the more hawkish members of the ECB will be more opinionated on this issue.

[1] *TLTRO= targeted longer-term refinancing operations.*

MULTI-ASSET

Reinforce cyclicality with relative value and hedges

GERMANO Matteo
Head of Multi-Asset

We maintain a pro-cyclical tilt and believe the reflation trade can continue, but investors must protect their equity and credit exposure through robust hedges

We continue to see support for risky assets as we move into 2021, backed by the shift from a contraction phase to a recovery. Importantly, the US Senate runoffs won by the Democrates strenghten the reflation trade narrative and the **positive backdrop for cyclical segments.** In this environment, **equity remains more attractive than bonds** and we see some upside over a one- year horizon. We are mindful that this recovery is different from those in the past in the sense that equity valuations are already high as we enter this phase and it is dependent on an effective, large-scale rollout of vaccines. As a result, **we recommend that investors be very selective and valuation-conscious across the asset spectrum.**

High conviction ideas

Overall constructive on DM equities due to positive momentum on PMIs and strong fundamentals, **we have upgraded our view on the UK** amid the current 'Brexit discount' and improving earnings revisions, but stay vigilant. On the other hand, we continue to believe that **Japanese and Pacific-ex-Japan (Australia) equities** should benefit from an economic rebound. Their high operating leverage means profit margins could grow in proportion to the higher sales we expect in 2021. On EM, we remain optimistic overall, with a positive view on **Asia**. In particular, with an eye for relative value, we now believe the Chinese A-share market (largely financials, conventional consumption) should do well vs MSCI China (ie, internet, e-commerce and telecoms) while financials should benefit from the improving economic momentum supporting the factor-rotation towards Value and Laggards; internet-related segments may be weighed on by a regulatory overhang. Financials will also benefit from favourable technicals, sentiment (potential inclusion in MSCI indices) and earnings.

On duration, we remain positive on the 10Y UST from a tactical perspective as tail risks for 2021 are tilted to the upside, linked with US political developments and the effects of a reflationary environment, especially if the Fed is perceived to be behind the curve. We also stay positive on US inflation. **On Euro peripheral debt**, our view remains constructive, especially on the 5Y BTP, which now offers lower potential for spread tightening, but is still supported by strong technicals. **We are positive on credit** as demand for carry and QE should support it, but we favour EUR IG over US due to attractive valuations, the ECB's recent extension of its purchasing programmes and lower leverage in EUR IG.

Investors' search for yield would support a 'smart income' strategy in EM HC where we stay constructive, but believe potential for spread tightening is higher in HY compared to IG. On FX, maintain our positive view on the Russian ruble, Mexican peso and Indonesia rupiah.

In DM FX, we are positive on CAD vs USD as we believe an economic recovery could weigh on the greenback, which already looks overvalued. On the other hand, growth in Canada is proving to be stronger than expected and the CAD has lagged the rest of commodity FX in 2H20. Another factor supporting the CAD is that carry is the highest in Canada among the G10. Secondly, **we upgraded our stance on the GBP** to neutral vs the USD and EUR in the prospect of a Brexit deal, but are monitoring the situation closely.

Risks and hedging

Additional waves of coronavirus infections and accompanying lockdowns, a premature withdrawal of stimulus and geopolitical tensions represent credible risks to an economic recovery. As a result, investors should maintain robust hedging structures in the form of derivatives, JPY, USD and USTs to safeguard credit and equities exposure. We also believe gold continues to act as a strong hedge in the current environment.

Amundi Cross Asset Convictions

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

Source: Amundi. The table represents a cross-asset assessment on a 3- to 6-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.

UST = US Treasury, DM = Developed markets, 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

"Great discrimination" in credit

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Head of Fixed Income

SYZDYKOV Yerlan
Global Head of Emerging Markets

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Economic reopening could raise inflation expectations in the US, affecting real yields. Investors should use credit research as a means to strike a balance between higher yields and high quality

The Q3 rebound in GDP numbers was stronger than expected, but renewed lockdowns due to the second wave of Covid-19 infections could affect economic activity in 4Q20 and 1Q21. On the vaccine front, a large-scale rollout and accommodative policies, as put in place by the ECB at its latest policy review meeting, should drive a recovery in global GDP in 2H21, providing a supportive environment for risky assets. However, in credit, there is a wide gap between valuations and fundamentals. So, we recommend investors balance their search for yield with quality credit through strong research and selection.

Global and European fixed income

With an overall cautious view on duration, we marginally downgraded our US stance to move close to neutral and maintain our defensive position on core Europe. We remain constructive on peripheral debt mainly through Italy (ECB support, strong EU policy response) even though the likelihood of spread tightening going forward is now lower. On the US curve, we stay vigilant on the 2Y, 10Y and 30Y segments. Finally, we upgraded our US break-even view, favouring 5Y over 10Y, and believe valuations are attractive in the EZ. The upside potential in break-even is not currently priced-in by the markets. **We remain constructive on credit**, particularly cyclicals, and see the recent rally as an opportunity to lock in some gains without altering our stance. Ihe scope for further spread compression is higher in HY vs IG, in BBB vs A-rated, and in subordinated vs senior debt. However, markets are not far from a situation where spreads do not appropriately reward for the risk. Hence, we stay very active. At a sector level, we are positive on financials and telecommunications, but cautious on basic utilities, healthcare and transportation.

US fixed income

As we move out of the pandemic and see large-scale vaccine distribution, we believe, the pent-up demand for goods and services from US consumers (supported by savings), coupled with the Fed's lower-for-longer stance, should push up inflation. Accordingly, we believe TIPS are a good way to diversify portfolios and protect from inflation. On the other hand, deficit spending and increased UST issuance may put upward pressure on yields, leading to some steepening. Hence, we remain defensive, but believe UST futures offer strong liquidity. On credit, active selection and research are crucial in allowing investors to de-risk portfolios. We think investors should avoid sectors that have completely normalised. In fact, current conditions are ripe for idiosyncratic aspects rather than a complete market beta exposure. In particular, consumer (esoteric ABS) and residential mortgage markets (agency mortgages) remain attractive in light of strong aggregate consumer earnings, savings and debt repayments.

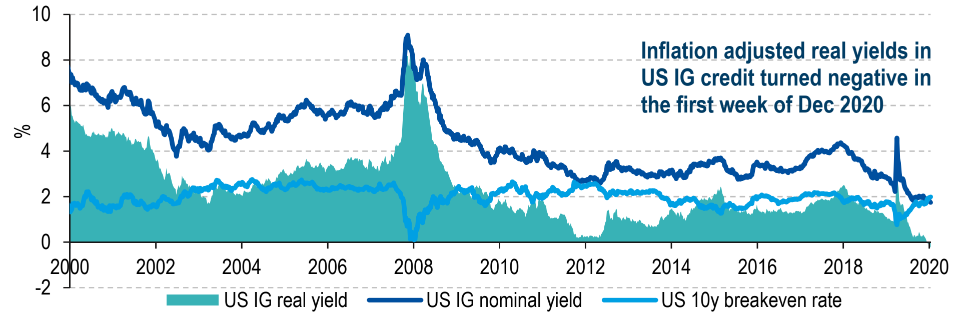
EM bonds

Overall positive on EM FI, we believe there is still room for spread compression in HY. Local FX is supported by low yields globally, benign inflation, stable US policy, and an early-cycle growth environment. Asian growth could outperform other regions in 1H21, offering selective opportunities. In Turkey, we acknowledge risks related to the BoP and lira, but believe there are opportunities amid credible normalisation of economic policies and cheap valuations.

FX

We are cautious on USD/JPY and USD/CNY given improving environment for cyclical FX. Our constructive view on NOK/EUR is also maintained.

Inflation and US IG credit



Source: Amundi, Bloomberg at 14 December 2020. Yield to worst for Bloomberg Barclays US Total Return Index.

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

Still room for Value to catch up

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Despite the recent outperformance of Value vs Growth, the catch-up potential for Value is significant and depends on earnings growth and economic normalisation

Overall assessment

The progress on vaccines globally and the approval of one in the UK and two in the US seem to have put a time limit on the pandemic, which is encouraging markets to look into the future. On the corporate front, earnings growth is expected to be significant in 2021, driven by continued stimulus and an economic recovery. However, stretched valuations in some segments, risks of multiple Covid-19 waves, and worries over corporate solvency require a selective approach. We believe that a fundamental, bottom-up analysis of businesses with quality balance sheets will be crucial for sustainable returns.

European equities

Given that reopening of the economy is very much dependent on a large-scale vaccine rollout, **we maintain a balanced stance, with a bias towards normalisation and recovery**. This supports our barbell stance regarding defensive sectors such as healthcare and telecommunication services, on the one hand, and quality cyclical stocks in the industrials and material sectors, on the other. While we are optimistic on the last two, we became marginally positive on financials, which should benefit from a shift towards Value. Interestingly, the last month saw **Value investing coming back in favour vs Growth**. However, on a longer historical perspective, **the Growth vs Value premium is still high.** We believe the potential for Value to outperform is still significant, but depends on the aforementioned vaccine rollout, economic recovery, improving PMIs, and direction of rates. Therefore, we prioritise process discipline and stock selection, all the while managing market and style risks. In contrast, we are more cautious on consumer discretionary, but have maintained our negative view on tech. In all cases, though, we focus on resilient businesses

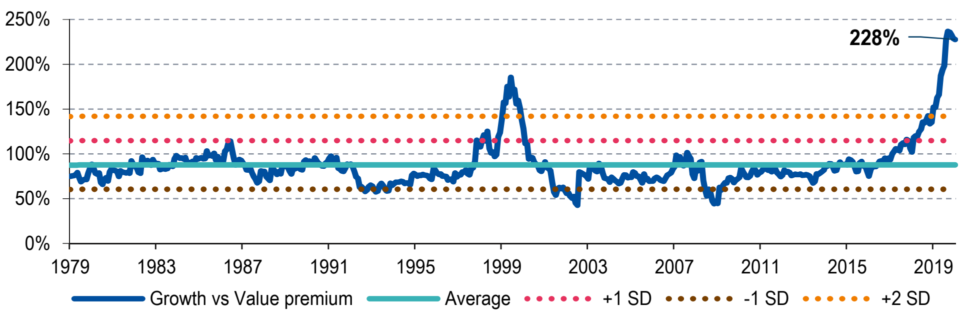
US equities

We believe equities are more attractive than credit from an income perspective, but, however, this doesn't eliminate the need to stay active. In fact, selection is even more important today because there are pockets of extreme valuations in the market. However, digging deeper, investors should avoid hyper-growth stocks and see if continuous fiscal stimulus, a recovery in 2021, and improvement in corporate earnings drive a **rotation from the mega-cap growth stocks towards more cyclical growth and cyclical value stocks**. The last should benefit from lower interest rate sensitivity. Growth names are more rate-sensitive because they have a higher dependency on future earnings and would be more negatively affected by rising discount rates. Conversely, financials, heavily represented in the Value universe, would benefit from a steeper yield curve. As a result, investors should: (1) consider shifting away from hyper-growth and high momentum stocks and move to reasonably priced, stable growth names (ie, medical devices); (2) aim to benefit from a rotation favouring high-quality Value stocks (ie, industrial automation, parcel delivery); and (3) explore opportunities in the ESG space.

EM equities

While geopolitical risks remain on our radar for EM assets, we continue to be constructive about exploring names in countries where economic activity has rebounded. At a sector level, we are selectively positive on tech and internet, consumer discretionary and industrials, but are mindful of extreme valuations in these areas. We don't like sectors where profitability may be restrained by government action. Stylistically speaking, our tendency is to look for value with sufficient cyclical growth and quality characteristics.

MSCI World growth/value - Composite valuation indicator (CVI)*



Source: Amundi Research, Datastream on 15 December 2020.
*CVI: based on a basket of criteria in absolute terms – trailing price-to-earnings ratio (PE), price-to-book value (P/BV) and dividend yield (DY), and ranked in percentile, ranging from 0% to 100% (the percentage of time this basket was cheaper since 1979: 0% never been cheaper; 100% never been more expensive).

THIS MONTH'S TOPIC

2021 global outlook reassessed

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As the Q420 is now closed, we confirm the "financial recovery regime" as our central scenario for 2021 with a higher conviction than in Q320. We expect better corporate fundamentals at a global level going forward. The rebound of EPS growth will eventually validate current asset price levels in the context of low interest rates. This explains our cautious optimism for the coming quarters. We have also analysed the sustainability of the ongoing risk rotation from Credit HY to value/cyclical equities. We confirm our constructive medium-term view with a continuation and maturing of the financial recovery regime.

I - Updating our 2021 economic outlook

Growth outlook reloaded

Implications of 4Q20

Compared to our previous quarter assessment**, the outlook for economic growth in 2021 has seen a mild shift in favour of Emerging Economies.**

Growth has become firmer in the US and has slightly improved in Japan driven by more substantial fiscal support plans in the US, and by a stronger base effect than in 2020 in Japan. In Europe, 2021 growth expectations are curtailed due to the current developments in the pandemic and weaker base effects than in 2020 (better-than-expected growth in Q3).

Growth in the Emerging Markets increased mildly in 2020 versus expectations on stronger-than-anticipated Q3, while expectations have remained stable in 2021 with the exception of Brazil and South Africa. In both of these countries, we expect a weaker base effect in 2021 than in 2020. Moreover, a slower resolution of the fiscal situation in Brazil and a less buoyant global economy at the turn of the year should weigh on growth, on top of the new lockdown measures enforced in South Africa.

The ongoing supportive policy mix is the main driver behind our constructive growth outlook in both the DM and EM. The effectiveness of the vaccine and herd immunisation through its mass distribution in 2021 are pivotal assumptions on which this outlook hinges.

Inflation in advanced economies is set to remain broadly in check or subdued, with of some temporary jumps linked to reversing base effects. While we see progress made toward the targets of DM central banks, we do not expect to see uncontrolled inflation in the foreseeable future. **Inflationary trends in the EM look more mixed.** In most cases, recent dynamics, particularly in China, have been dictated by specific and seasonal factors, and therefore temporary. Still, there are idiosyncratic stories, such as Turkey, where inflation should remain very high due to strong currency depreciation, a rise in electricity prices and the progressive phase-out of various VAT cuts introduced in 2020. **Overall, inflation in emerging economies is already at or closer to the CBs targets than in advanced economies.**

Reiterate our 2021 global growth forecast

From a growth perspective, **our global outlook for 2021 remains broadly stable**; while still dominated by base effects, it also factors in moderately stronger quarterly growth patterns. As of December 31st, our 2021 global growth assumption ranges from **4.9% to 5.7%.** The **fiscal lever will be a key driver** in supporting the recovery, especially in AEs. In the US, while the vaccination campaign remains in progress but virus containment measures could still dampen activity. A new fiscal package will support the economy in the first half of the year (worth almost 1% of 2021 GDP growth, according to our calculations). There is some upside to our expectations as we conservatively embedded a skinnier package in our original projections than the USD900b signed by the US President on December 27th. Moreover with the majority in Congress post the senate runoffs in Georgia, Joe Biden should be able to add further fiscal stimulus. In the Eurozone, the *Next Generation EU (NGEU)* plan is a key factor that is expected to drive growth above potential from the second part of the year, particularly in key vulnerable countries. We expect EZ growth to be steady and range from 4.3 to 5.1% in 2021 and from 3.6 % 4.2% in 2022 outperforming the US (see table following page). The combination of the vaccination campaign reaching "herd immunity" level and the release of pent-up-demand reinforcing the plan's impact, creating a sort of virtuous cycle, is a key feature of this scenario. We should therefore be vigilant on the implementation risks.

With growth recovering somewhat faster, the inflation outlook has been broadly muted, in particular in the DMs due to a broad deceleration in the second half of 2020. The new wave of the virus in Q4 introduced an additional source of volatility to the macro data, with the new restrictions impacting activity, particularly in the services sector. While representing only a proxy, a broad set of high-frequency indicators such as mobility

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data and electricity consumption tend to show a new decline in Q4 in areas where more severe lockdowns were implemented (e.g. the Eurozone), in line with the scenario of a gradual but uneven recovery.

Relapses in the real economy will occur due to virus outbreaks, while policy intervention will hopefully be an option to help speed things along. Moreover, the world's central banks are committed to maintaining unconventional monetary policies and easing financial conditions for a long period of time. **This will support the financial markets when corporate fundamentals rebound**[1].

As a conclusion, the new wave of infections and the selective lockdowns implemented in several countries across the different regions makes the global economic recovery increasingly uneven and heterogeneous. The speed and effectiveness of the vaccination campaign will be key drivers in releasing pent-up demand, and shaping the recovery growth trajectories, together with the fiscal and monetary policy mixes.

[1] *In our central scenario, this translates into pre-Covid 19 economic levels not being reached for several more quarters on average (with the exception of China, the only economy showing a proper V shaped recovery).*

What surprised in the Q4 2020

While uncertainty remains pervasive, our short-term cautious optimism takes the following into account.

- **While progress on vaccine availability increased somewhat faster than we had anticipated, the new wave of infections across regions and particularly in the US and Europe may offset the confidence from the early start of the vaccination campaign**. The health measures to tackle the new wave, implemented with different degrees of severity and implications for mobility, are generating a remarkable deceleration in high frequency data, and in some regions causing an economic contraction. While in the US these developments do not seem to have compromised Q4 growth, even if it is has slowed significantly, in Europe there are signs of an outright contraction, albeit at a fraction of that seen in Q2. The recovery should resume gradually and unevenly from Q1 2021. Growth over the year should be driven by extraordinary base effects which should offset the unprecedented losses in Q2 2020.
- In the US, the odds of a **bi-partisan fiscal package** being delivered during the lame duck period seemed low a few months ago, yet before the year-end Congress approved a USD900+ billion fiscal package that should offset the weak momentum seen in Q4, lift households' disposable income in the first half of the year, and revive growth momentum.
- In the EU, the **recent agreement on the NGEU multi-annual budget** gives the green light for its implementation, overcoming the opposition previously expressed by Poland and Hungary, which made the negotiations tougher and increased uncertainty around its delivery and the timing of its implementation.
- The **financial markets kept a close eye on the pandemic logistics** and moved on the positive vaccine-related news flows, the fiscal plans and the reduction in political risk, surprising us on the upside more than any rosy expectations, and implying a tactical repositioning.

Macroeconomic forecasts (with information available as of December 31, 2020)

Annual averages (%)	Real GDP growth (%)			Inflation (CPI, yoy, %)		
	2020	2021	2022	2020	2021	2022
		range				
Developed countries	**-5.7/-5.3**	**3.7/4.5**	**2.8/3.4**	**0.7**	**1.3**	**1.6**
US	-3.7/-3.3	3.7/4.7	2.4/3.0	1.3	1.9	2.0
Japan	-5.6/-5.0	2.3/2.9	1.3/1.9	0.0	0.1	0.2
Eurozone	-7.6/-7.0	4.3/5.1	3.6/4.2	0.2	0.9	1.4
UK	-11.5/-11.1	3.5/4.1	4.4/5.0	0.9	1.7	1.9
Emerging countries	**-2.9/-2.2**	**5.7/6.5**	**3.9/4.9**	**3.9**	**3.6**	**3.7**
China	1.4/2.0	7.9/8.5	4.9/5.5	2.5	1.4	2.2
World	**-4.1/-3.5**	**4.9/5.7**	**3.5/4.3**	**2.6**	**2.7**	**2.8**

Source: Amundi Research

THIS MONTH'S TOPIC

We are convinced that inflation next year will trend higher and episodically spike mainly on base effects

Inflation: the elephant in the room

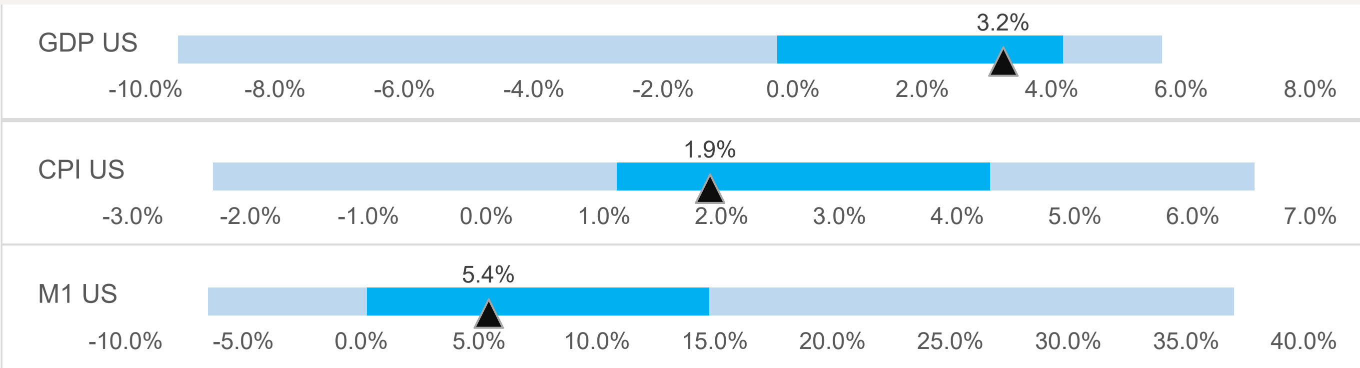
In 2021, inflation and inflationary expectations are likely to be in the spotlight. During the 4th quarter, **inflation was a relevant factor but not a market mover.** US inflation was weak on key drivers such as shelter and medical services decelerating considerably, while EU inflation remained in negative territory. We therefore feel it would be premature to assume that inflation expectations are anchored at higher levels.

In general, we expect **fiscal and monetary policy coordination to continue, with monetary policy facilitating fiscal expansion regardless of short-term inflation pressures**. In fact, the major DM central banks are revisiting as expected their longer-term policy guidelines after constantly missing their inflation targets and thus allowing for extended periods of policy easing even in the case of modest increase of inflation. In EM, by contrast, the monetary authorities must balance their policies more carefully in light of very different inflation dynamics, and we expect a stable monetary policy stance (a marginal tightening in some cases only) on the back of a gradual recovery later on.

As a conclusion, we believe **inflation in DM** may experience **unusual volatility** in the months to come, due to lockdown-induced distortions and base effects, which should reverse in 2021. As long as the output gap remains open, global and local deflationary forces may put a lid on inflation, whilst the fading negative drag from the oil base effect should help inflation grind higher over next 12 months together with vanishing base effects from VAT cuts, where implemented (e.g. Germany). **In EM**, **the overall picture is expected to remain benign, with headline inflation remaining within or close to the CBs' targets;** however, price dynamics and expectations are worth monitoring, given the huge dovish efforts made by most CBs.

Mapping US economic expectations.

Looking at Q4 2021, strong and above median growth does not lead to persistent inflation overheating, notwithstanding the monetary policy support delivered so far. Quite the opposite, inflation moves towards the target but remains subdued.



Source: Amundi Global Research, Bloomberg, Eikon – Datastream, January 2020.

Methodology: The table represents each variable (e.g. GDP US YoY, CPI US YoY, US M1 acceleration) expected value in Q4 2021 (black triangle) compared to two ranges:

- light blue: the historical min and max values reached by the series over the sample period (starting 1988)
- dark blue: the min and max values of the variable distribution conditioned to the estimated probability of each macro-financial phase as computed in the AIP framework.

This enables to evaluate how the forecasts position compared to the typical distribution of the expected financial regime as per the Advanced Investment Phazer 12 months ahead.

II - Rebalancing the probabilities of our scenario

As 2021 gets underway**, we expect the road to recovery to remain bumpy**, shaped on the one hand by waves of optimism linked to **progress in the mass vaccination** campaign and on the other hand by **virus containment measures**, which we do not expect to be lifted fully before Q3.

We reviewed the probability assigned to our central and alternative scenarios in terms of expected financial regimes compared to the previous quarter. **Our scenarios are contingent on the pace of the massive vaccine rollouts**, which we expect to be non-linear and uneven

▶ Increasing the probability of our central scenario to 75%

We have a higher conviction on our **central scenario** and we raise its probability from 65% to 75%. This scenario assumes that getting the world back in order will be a multi-year process, with relapses in the real economy due to virus outbreaks, while policy intervention will be an option to help speed things along.

THIS MONTH'S TOPIC

Q4 recovery path diverges across regions as a new wave of infections prompts lockdowns, partially offsetting the sentiment boost provided by the earlier-than-expected start of the vaccination campaign

The risk rotation that began in Q4 20 should continue over the coming quarters

According to our estimates, corporate earnings will prove resilient and rebound from their 2020 lows as economic activity resumes. Managed low interest rates should further lift the equity markets, helping to maintain the remarkable gap that emerged between the financial markets and the economy during 2020, sustained by resolute policies.

We confirm our constructive medium-term view of a continued and maturing recovery, with more cautious optimism in the short term as far as financial markets are concerned.

Our optimism hinges on three key achievements of the 4th quarter:

1) **tangible progress in the Covid-19 vaccine** front since November, leading us to be more confident of a "vaccine-enabled" recovery, supported by
2) gradual **progress on fiscal support** allowing us to improve our economic projections[2]. We believe that fiscal expenditure will have the highest impact by selectively addressing (welfare) support in those sectors that have been hardly hit by the health restrictions. All G4 central banks have further committed to maintaining accommodative financing conditions to stabilise the financial markets and monetise sovereign debt issuances to boost economic growth.
3) major **political risks** (including US elections, hard Brexit) have disappeared and therefore reduced financial markets volatility.

The probability of the downside scenario remains high at 15%

Markets participants were a bit early in pricing in a "vaccine enabled" economic recovery. Our downside risks, priced with a probability rate of 15% (down from 25%), remain high and above the historical trend, Hence our cautiousness on the short-term market moves.

We see three main catalysts, which could trigger our downside scenario:

1) **a genetic evolution of the virus** which could drive the pandemic out of control again and lead to negative growth shocks.
2) **policy mistakes,** such as execution risk of fiscal plans, or monetary policies being paused or seeing a correction in part of their accommodative stance. The Federal Reserve for instance could be under pressure because of a free fall in the USD, de-anchoring rates or inflation expectations. The latter being consensus trade, it represents a risk per se and might play out as game changers in the scenarios.
3) **a prolonged economic downturn** affecting business and consumer confidence and looping into sectors that have not yet been infiltrated by the crisis (i.e. the financial sector) and causing the exceptional economic crisis to evolve into a financial crisis.

The upside risks with 10% probability

Our upside scenario entails the health crisis being solved in H1 2021, confirming a sustained **"vaccine- enabled" recovery.** An orderly rebalancing of policy mixes with a boost in economic activity would intiate a virtuous path of economic recovery, prompting productivity gains on new digital/green developments, and a faster normalisation. Private demand would resurge, leading to a demand-led increase of inflation albeit benign.

Investment implications

Given the new probabilities of our central and alternative scenario, we recommend well diversified portfolios, with balanced risk exposures, which are resilient to rising volatility in the case of negative shocks pertaining to growth or institutional policies. We expect corporate earnings to rebound, underpinning even higher risky asset price levels in the context of interest rates controlled by central banks. This should sustain the ongoing risk rotation from Credit HY to value/cyclical equities and into EM assets.

III - Medium-term Investment outlook

Conveying our top-down assessment into the Advanced Investment Phazer framework

We have described all the ingredients of our cycle indicator, the Advanced Investment Phazer, which underpins our medium-term investment views. Within this framework, we bridge our views and expectations on the macro outlook to our convictions and investment strategy.

We confirm the financial "recovery regime" as a central scenario (with 75% prob.), with growth and macro determinants remaining paramount. On our economic radar, the softening seen in Q4 2020 should not derail the 2021 rebound. Nevertheless, the convergence of economic growth to pre-crisis levels will be a slow and bumpy path due to the serious structural damage caused by the pandemic to labour intensive sectors.

Our analysis based on **long-term growth determinants shows that potential growth has been severely hit by the**

[2] ***This time, we explicitly added fiscal expenditure support*** *(i.e. approx. USD500bn for the US with effects in Q1 and Q2 mainly, computed in line with CBO fiscal multiplier estimates; for the Eurozone, between 15% and 20% of the allocated RRF grants for each beneficiary country, with effects from Q3 mainly, estimated with multipliers in line with each DBP presented to the EU Commission).*

THIS MONTH'S TOPIC

pandemic via all three growth channels (loss of productivity, lower capital investment and diminished labour force participation), effects that will be reversed only gradually over the medium term. However, **corporate earnings should be more resilient and faster in recovering to pre-crisis levels** (in the US, we expect 2021 EPS to drift even higher than December 2019 levels). More importantly, **asset price dynamics should not be a game changer for CBs' monetary policies**, and liquidity injections should remain solid, underpinning asset reflation and preserving positive financing and financial conditions.

Policy accelerators support risk assets, but the decoupling from their fundamentals increases downside risks. This is reflected in the probability we assign to the downside scenario (15%), which includes a potential market correction above 10% i.e. in line with historical average.

Search for yield and diversification

Within this environment, **the search for yield is still the dominant theme** along the fixed-income spectrum: the focus switches however to **emerging market bonds, for diversification purposes and expected returns perspectives.** In fact, the mix of a weak US dollar, the time premium adjusted income and the improving economic conditions in the EM regions are tailwinds to global emerging market bonds. Moreover, easing financial conditions pioneered by central banks are preventing volatility spikes in GEM yield curves too**.** We reiterate our preference for **inflation linkers** over government bonds. Inflation expectations are anchored at low levels, and this is therefore a cheap hedge to have in case they move higher going forward.

Equities are the favourite pick within risky assets

The **resilience of corporate earnings** in the context of managed interest rates should help equities to hit new highs in 2021-22 without assuming skyrocketing multiple levels. We expect price-to-earnings ratios to revert gradually to the historical median. Therefore, **from a risk return profile, the equity market remains the favourite pick within risky asset classes.**

Moreover, we expect the ongoing rotation from Credit HY to equities, at least in developed markets, to continue. Although the volatility of HY decreased significantly in 2020, the potential upside from extremely and artificially tight spread levels is more limited than in past recoveries.

Q4 asset class rotation and the performance of risky assets significantly reduced the market dislocation and the undervaluation in the laggards (global equities risk premium vs. yield, cyclical assets, commodities and in general all reflation trades).

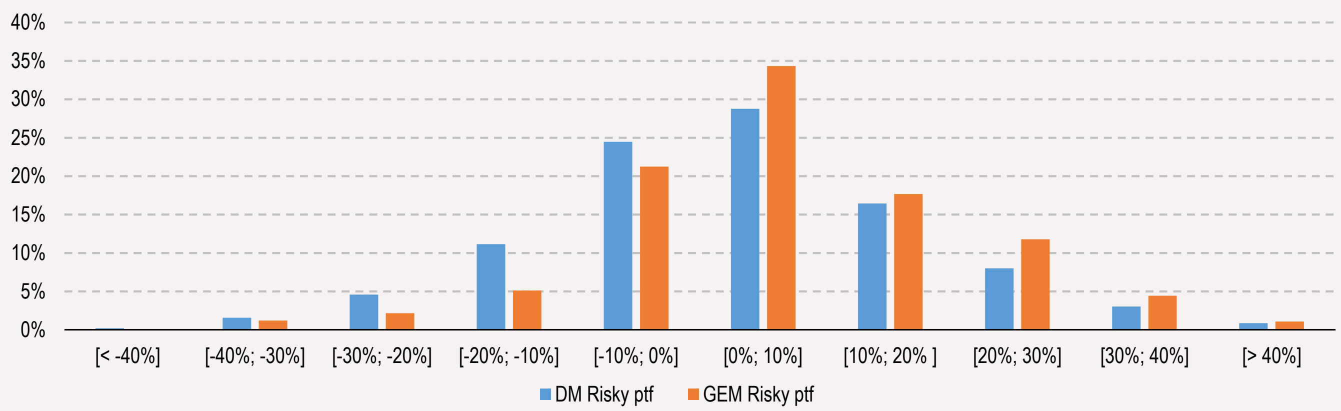
Reality check on the continuation and sustainability of the rotation

According to our analysis, **the rotation is sustainable over time.** We recognise **higher potential in the Eurozone when switching from HY to equities**; the recent catch-up of this trade in the US has almost exhausted the relative appeal in the region. **Investment opportunities in the GEM risky assets spectrum will continue to be available in 1H21.**

In light of these considerations, we feel it is appropriate to **maintain the rotation trade, focusing even more on lagging asset classes and playing this theme at cross-asset level in order to guarantee the right risk diversification**.

In the recovery financial regime, our central case, Global Emerging risky assets (HY+Equities) outperform on average Developed Markets risk assets mainly thanks to cheaper top down valuations.

1/ **Expected returns - DM Risky portfolio vs GEM Risky portfolio**

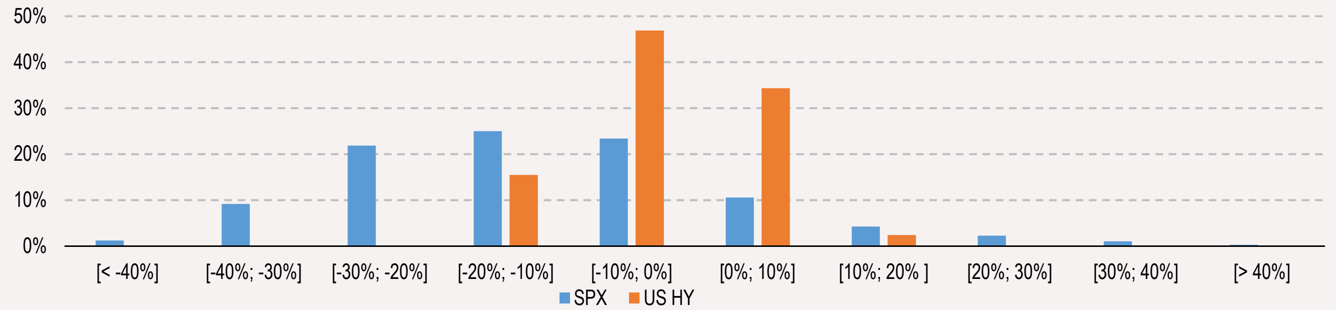


Source: Amundi Research, Bloomberg, Standard & Poor Website, January 2021, X axis reports portfolios expected return range, y axis reports the frequency of the probability distribution.

THIS MONTH'S TOPIC

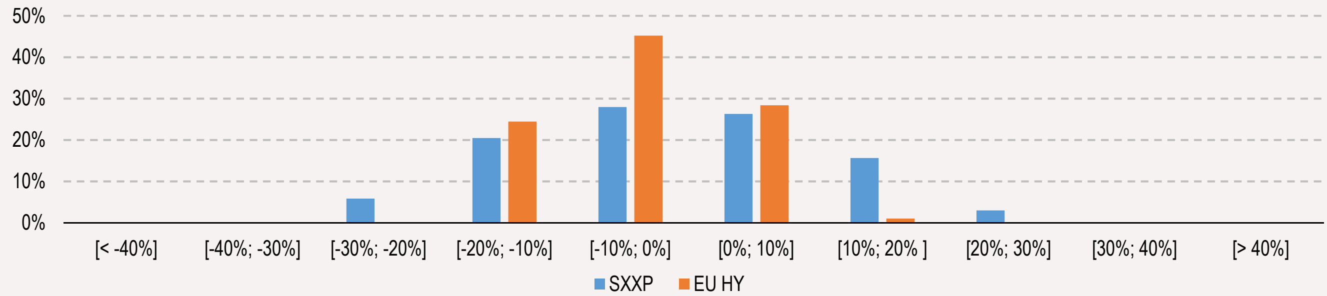
In a cross asset portfolio, the rotation from HY to Equities case holds both in the Eurozone (EZ) and US. However, when considered regionally in relative terms, the EZ shows more upside.

2/ Fair value - US HY vs US Equity



Source: Amundi Research, Bloomberg, Standard & Poor Website, January 2021, X axis reports portfolios expected return range, y axis reports the frequency of the probability distribution.

3/ Fair value - EU HY vs EU Equity



Source: Amundi Research, Bloomberg, Standard & Poor Website, January 2021, X axis reports portfolios expected return range, y axis reports the frequency of the probability distribution

Methodology: Expected returns (and fair values) forecast distributions based on scenario simulations generated from our internal macro forecasts and the financial regime probabilities as resulting from our Advanced Investment Phazer. Simulated distributions capture asymmetries, upside and downside risks underlying the central scenario for all asset class universes considered. In the last chart, we show two balanced portfolios (DM and GEM risky portfolios) based on 50% DM HY + 50% DM Equities distribution and 50% GEM HY + 50% GEM equities distribution respectively. Based on our calculation, portfolios showing strong exposure to EM asset classes should outperform DM-based exposure.

Conclusion

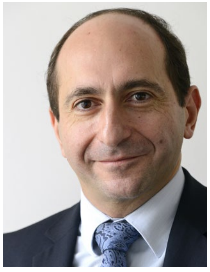
Q4 2020 confirmed the economic and financial cycle roundtrip while the 2021 financial recovery regime will ensure further room for risky asset class rotation. We think the economic recovery will entail a gradual but uneven catch-up process. Relapses in the real economy will occur due to virus outbreaks, while policy intervention should help speed things along. In this environment, growth, rates, inflation, monetary and fiscal policies are strongly interconnected, which means an idiosyncratic risk can propagate a systemic one, even if this remains confined to our downside risk scenario.

The most relevant risks to our central scenario still relate to (1) the evolution of the pandemic in Q1 21, leading to further negative growth shocks, increasing default rates and bankruptcies as a result of prolonged economic downturn affecting business and consumer confidence, and (2) execution risks related to ambitious fiscal stimulus plans.

Although a short-term market correction is worth considering, according to our analyses, the risk rotation story remains sustainable over the medium term. After the recent catch-up in the US, we expect higher potential in the EZ when switching from Credit HY to equities. Investment opportunities should continue to be available in the Emerging Markets in the first half of 2021. In light of these considerations, we believe it is appropriate to maintain a risk rotation focusing even more on lagging asset classes and playing this theme at cross-asset level in order to **maintain the right portfolio diversification**.

Finalised on 06 January 2021

THEMATIC



BOROWSKI Didier
Head of Global Views

PERRIER Tristan
Global Views Analyst

Foreign investors who are under-exposed to Eurozone assets, may want to reposition themselves on them, which would push the euro even higher. Mind the overshooting!

Is the euro's rise a sign of greater resilience?

The complexity and fragility of European institutions have contributed to maintaining a specific political risk premium on European assets, including the euro. But institutions were ultimately strengthened when negotiators agreed in July to launch the New Generation EU package. The euro's recent appreciation may be an early sign of decline in this "risk premium". Foreign investors may therefore want to rebalance their portfolios in favour of Eurozone assets, which could push the euro higher. Should the euro appreciate too fast, the ECB would not stay on the side-lines.

The Eurozone strengthens through crises

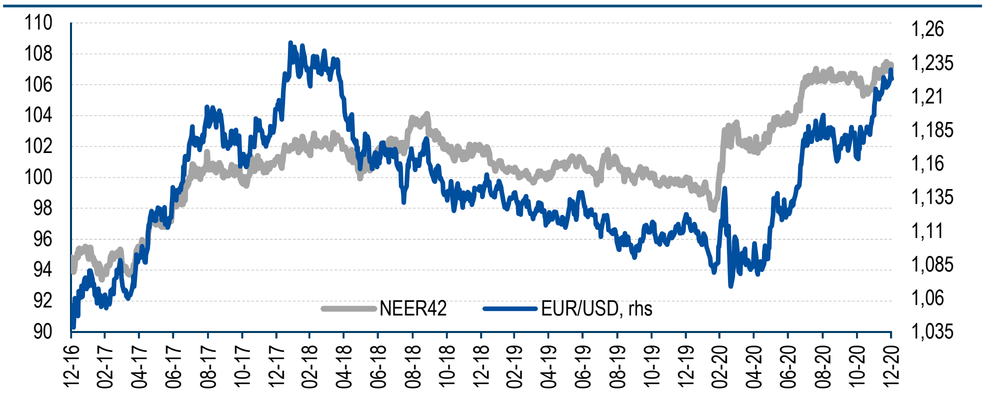
The 2010s have been fraught with events that were perceived by markets as serious challenges for the integrity of the EU and Eurozone: after the sovereign debt crisis of 2011-12 came the Greek crisis of 2015, the Brexit saga, some nervousness before the 2017 French elections, and the tensions between Italy and the rest of the Eurozone following the 2018 Italian general election. These episodes, on top of low growth, and the perceived complexity and fragility of European institutions, contributed to maintaining a specific political risk premium over European assets.

The Covid crisis was initially seen as another existential threat for these institutions as it brought border closures accusations of uncooperative behaviour and perceived insufficient solidarity among European countries. **However, after a few weeks of doubts, the "make" won over the "break", and institutions were finally not weakened but strengthened** when negotiators agreed in July to launch the EUR 750 bn New Generation EU (NGEU) plan, which has been identified as a major new step in terms of fiscal solidarity. Indeed, by borrowing large amounts in the EU's name, to be repaid in principle using the EU's "own resources " (new taxes), by distributing the larger part of these funds as grants, and by allowing their use partly for cyclical economic support, this new instrument is bringing European integration beyond some of the previous "red lines" of Northern European countries.

In 2021, the political agenda seems less risky. The two main elections in the Eurozone will be in the Netherlands and Germany. They will deserve scrutiny (notably to gauge the strength of Eurosceptic sentiment, and because Merkel's successor should at last emerge) but are very unlikely to result in political equilibria that could be perceived as bringing threats to Europe's institutional integrity. On the positive side, while some frictions can happen over the actual deployment of the NGEU (expected in H2 2021), the political thrust behind this project is now very strong. **The cooperative approach brought by the Recovery Fund is likely to spill over to accelerate other institutional developments that have also seen progress** (such as the ESM and Banking Union) or have been initiated (the European "bad bank") in 2020. Moreover, the EU and UK have just found an agreement eliminating the risk of a major bilateral trade shock in 2021, even though residual uncertainty persists over the deal's implementation and provisions for trade in services.

Finally, the Biden Administration is expected to be more friendly towards Europe, in particular by adopting a more cooperative approach and abandoning Trump's mercantilist approach. And the good news is that European "Eurosceptic" leaders will have much less support in this new administration.

1/ **EUR/USD and Trade-weighted EUR Basis 100 on 31/12/2016 for NEER (lhs and rhs: proportional scales)**



Source: ECB, Datastream, Amundi Research - Data as of 31 Decembre 2020

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The appreciation of the euro may be the price to pay for greater resilience

From the markets' point of view, **it is very probable that part of the European yield spread compression, and even part of the euro's appreciation since the summer of 2020 can be attributed to a diminishing perception of European "systematic", institutional risk**. A key question is now whether this specific European risk premium will compress further in 2021. International investors remain underexposed to European assets although this trend has started to reverse itself at the end of 2020 starting from a low base. But we've had similar episodes in the past decade, and this well entrenched underexposure is due mainly to low yields across the Eurozone bond markets and a lack of growth stocks versus the US or EM.

The trade-weighted euro has appreciated by 6% since the beginning of 2020. At USD 1.22-1.23, the euro is rather close to its fair value calculated on the basis of traditional valuation models (our forecast is 1.25 for end 2021). At this level, European companies have no real problems of competitiveness. As for exports, they will more sensitive to the revival of global demand. In any case, the recovery will be driven mainly by domestic demand in 2021.

But one thing is certain**: the euro's appreciation cannot be explained by the relative growth dynamic**. Eurozone GDP will not return to its pre-Covid level until the end of 2022 therefore one year after the US GDP.

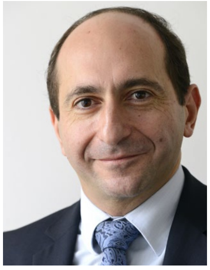
That said, the progress made notably on the front of its institutions (Recovery Fund and banking union) will increase Europe's resilience to the shocks of the future. Foreign investors, who are under-invested in Eurozone assets, may want to reposition themselves on them, which would push the euro even higher. In addition, **foreign CBs could seize the opportunity to rebalance their foreign exchange reserves in favour of the euro. The euro's recent appreciation may be an early sign of a decline in the «political risk premium» that has weighed on the single currency and European assets in recent years.**

... but mind the overshooting

The past decade has shown that the euro can soar without any link to growth (close to USD 1.50 in 2011 and 1.40 in 2014). However, not all countries are equally sensitive: peripheral countries (and France) have suffered more than Germany. **Eurozone policymakers must ensure the EZ is not the "victim of its own success" in the recovery phase, especially as the recovery is expected to be much slower in the southern countries (Italy and Spain).** There is little that governments can do. The ball is clearly in the camp of the ECB. This is all the truer as the inflation impact of the euro's appreciation is particularly unwelcome for the ECB. Indeed, the ECB found empirical evidence that it is when the euro appreciates rapidly that the impact on inflation is most pronounced. And Fabio Panetta stressed on 10 December that the euro's rise had already led the ECB to revise downwards its inflation forecasts for 2021 and 2022. **The ECB will therefore not let the euro jump without reacting. The most effective channel to stem a rise of a currency is that of interest rates.** The bar is probably quite high for the ECB to lower its deposit rate again. On the other hand, the ECB could soon start to explicitly mention this option to contain the rise.

Finalised on 07 January 2021

THEMATIC



BOROWSKI Didier
Head of Global Views

United States: the power of Executive Orders

Following the elections in Georgia, the Democrats have a very small majority in Congress. To facilitate governance, the new administration is likely to continue to govern using Executive Orders (EOs). Their use has grown over time, and they have become a full-fledged instrument of governance.

Executive Orders can cover a very wide range of public actions and are in practice rarely repealed

Executive actions: an imprecise definition

An EO is a written statement that the President issues and signs to *"direct or instruct the actions of executive agencies or government officials, or to set policies for the executive branch to follow"*. **An EO has the same force as a law passed by Congress** (unless it conflicts with an existing federal law).

It should be noted that there are two other types of executive actions, with which EOs are often confused: the memorandum and the proclamation. These are presidential acts which are similar to EOs (in that they have the force of law) but unlike an EO, which has to be signed and published, there is no formal procedure for a memorandum or proclamation.

According to the Congressional Services, there is no direct *"definition of executive orders,* *presidential memoranda, and proclamations in the U.S. Constitution, there is, likewise, no specific provision authorizing their issuance."*

Historically, military operations have naturally been the area in which presidents have made the most use of EOs. The president, as commander-in-chief of the armed forces, can use executive action to define military policy.

However, Article II of the US Constitution confers executive powers on the President, in effect the Commander-in-Chief, and stipulates that the President "shall take care that the Laws be faithfully executed." **In practice, therefore, EOs can cover a very wide range of public actions.**

Executive actions allow the President to take decisions bypassing Congress. Every President since George Washington has used EOs in various ways. The emancipation proclamation by President Abraham Lincoln's in 1863 is the most famous executive action[1] in American history. EOs have become more controversial over time as presidents are using them in more and more new ways. The use of EOs has expanded to many areas. Lack of majority and increased polarisation are pushing presidents to use EOs as a substitute for legislation. But this is nothing new: the use of EOs played a key role in the Civil Rights movement: Affirmative action and equal employment opportunity actions were taken by Presidents Kennedy and Johnson using EOs.

Donald Trump has been particularly active in this area but was not the most active in history; he issued 202 EOs in a single term, which is faster than the majority of American presidents since WWII (276 for Barack Obama in two terms, 291 for George W. Bush in two terms and 364 for Bill Clinton in two terms). However, Trump issued less than Jimmy Carter (320) in one term. And this figure is a far cry from the record held by President Franklin Roosevelt (3,271 EOs recorded between 1933 and 1945) under exceptional circumstances (crisis and war); and still far below the levels achieved by some other presidents: Theodore Roosevelt (1,081), Woodrow Wilson (1,803), Herbert Hoover (968), Harry Truman (907).

However, Donald Trump's use of EOs was particularly criticised as it allowed him to reconfigure (in peacetime) the entire US trade policy, in particular to strengthen his electoral base. A use far removed from the spirit of the constitution.

An EO can be terminated in theory, but this rarely happened in practice:

- **Congress can override an EO by removing the necessary funding.** In which case the law passed prevails over the EO. However, the President can then veto this provision of Congress; and Congress can only override this veto by a two-thirds majority, which is very difficult to obtain. This is why friction with Congress has no consequences.
- **A court can also annul an EO.** But it has to show that the President acted outside his authority, which is difficult given the broad prerogatives of the President. The President can base his authority on the Constitution, his power as commander-in-chief or a law.

[1] *Technically, it was a proclamation and not an EO (in both cases the President acts by bypassing Congress). In an emergency, the President can issue decrees with almost unlimited power. Abraham Lincoln used an EO to fight the Civil War, as did Woodrow Wilson to manage US involvement in WW I, or Franklin Roosevelt to approve Japanese internment camps during WW II.*

THEMATIC

In practice, the courts have only struck down an EO when he violated[2] civil rights.

- **However, an incumbent president can cancel a decree or issue a new EO that contradicts a previous EO,** which amounts to the same in practice. This frequently happens when a new president takes office[3]. President Biden can therefore be expected to use this means to reverse some of Donald Trump's decisions as early as January 20, 2021.

It must be noted that the EOs issued by Donald Trump have not been challenged either by Congress or by the courts. It is therefore **likely that the use of EOs will continue with President Biden, including on trade policy issues** (US-China relations).

Moreover, as far as regulation is concerned, there is nothing to exclude the use of EOs, especially when it comes to opposing monopolistic positions (as EOs can rely on existing antitrust laws). There is, however, one area where the President can certainly not act through EOs, and that is in most fiscal matters. Ultimately, this is why the elections in Georgia were so decisive for economic policy.

Conclusion: the US President has broad powers that should not be underestimated even when Congress is not on his side. **Donald Trump's actions via EOs has set a precedent** that could bring about a lasting change in the practice of governance in the US (trade policies). **It will be interesting to see the extent to which Biden can and wants use EOs to combat growing inequalities in the same vein that Kennedy used them to fight racial discrimination.**

Finalised on 05/01/2021

[2] *The most famous example of a court overturning an executive action occurred in 1952. During the Korean War, President Truman seized steel mills to break a strike using his authority as Commander-in-Chief. The Supreme court quashed Truman's EO on the grounds that his authority as Commander-in-Chief did not authorise him to seize private property.*

[3] *Barack Obama, upon taking office, cancelled an EO by George W. Bush that limited funding for stem cell research. Donald Trump issued an executive memorandum contradicting President Obama's previous memorandum on the Deferred Action for Childhood Arrivals (or "DACA") initiative.*

CENTRAL & ALTERNATIVE SCENARIOS

Monthly update

This month, we update the probabilities and narrative of our central and alternative scenarios, taking into account 4Q20 developments in vaccinations, fiscal and monetary policies, and (geo)politics. We have a higher conviction on our central scenario and we are raising its probability from 65% to 75%. We are lowering the probability of our downside scenario from 25% to 15%, which remains above historical levels. We confirm our constructive medium-term view on the "financial recovery regime", with more caution in the short-term on financial markets, given the virus-dependent news flow.

DOWNSIDE SCENARIO 15%

Secular stagnation

Analysis

- Genetic evolution of the virus drives the pandemic out of control and leads to another negative growth shock
- Policy mistakes and execution risks of fiscal plans
- Pause or rollback of accommodative monetary policies, due to internal (asset bubble) or external (FX) constraints.
- Protracted economic downturn, due to uncertainty (lack of visibility), affecting business and consumer confidence
- Economic crisis evolves into a financial crisis
- Protectionism and de-globalisation accelerate, negatively affecting trade and global value chains

Market implications

- Favour cash and US Treasuries
- Favour gold, CHF and the yen
- Play minimum volatility strategies

CENTRAL SCENARIO 75%

Multi-year and multi-speed recovery

Analysis

- Multi-year process to get the world economy back on track, with a bumpy road to recovery
- Relapses in economic growth, due to virus outbreaks and lockdown measures until 4Q21
- Massive vaccine rollouts in 1H though uneven across regions
- Strong political commitment to mobilise fiscal policies in AEs, but timely execution is a risk
- Accommodative monetary policies continue, in order to cope with deflationary risks and rising public debt
- Positive momentum in corporate earnings and diminishing solvency risks
- Ratio of global trade to global GDP slips further but lower geopolitical tensions after the US elections
- The Covid crisis to exacerbate income and wealth inequalities (risk of increased social tensions)

Market implications

- Contained steepening of US Treasuries yield curve
- Progressive rotation from Credit HY into equities
- Equity thematics are cyclical sectors and are more domestically driven
- Maintain income pockets: EM bond, and credit IG
- Favour gold on pervasive uncertainty, deflation and recession fears

UPSIDE SCENARIO 10%

V-shaped recovery

Analysis

- Health crisis resolved by the end of 1H21, thanks to mass vaccination and efficient lockdown measures
- Sustained "vaccine- enabled" recovery
- Productivity boosts on new digital and green developments
- Faster normalisation of economic activities
- With lower uncertainty, policy boosters feed through to the real economy and financial markets, closing the gap between manufacturing and service sectors
- Sustainable growth and diminishing need for further (fiscal) policy support

Market implications

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

TOP RISKS

Monthly update

Risks are clustered to ease the detection of hedging strategies, but they are obviously linked. We maintain the overall narrative and change the probabilities of risks in light of the recent developments.

ECONOMIC RISK 20%

- **Covid-19 vaccine rollout issues**
  - Unexpected logistic or side effects issues of the vaccine could have a very negative impact on investors and business sentiment, which has improved significantly since November
  - One or several virus variants that would make existing vaccine ineffective would undermine the expectations of an end soon to the pandemic
- **A protracted recovery with multiple relapses** might hit business and consumer confidence, looping in sectors that have not yet been directly hit by the pandemic, such as financials
- **Underestimated hysteresis effects in the labour market**, with rising unemployment and uneven impact on social groups, could undermine the recovery
- **A rebirth of inflation and a second taper tantrum**
  - The risk is very low in the short run, but upward inflation pressure could build up over time, as the epidemic fades away
  - QE programmes may become problematic when inflation enters the equation
  - Inflation dynamics and central banks reaction function could be sources of uncertainty, in particular in EM, where inflation is close to CBs target
  - Federal Reserve early exit or miscommunication could lead to a second taper tantrum similar to 2013

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

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

FINANCIAL RISK 15%

- **Corporate solvency risk**
  - Prior to the Covid-19 crisis, corporate leverage reached levels above pre-GFC highs
  - The magnitude of the recession has increased solvency risks, regardless of central banks' actions and government guarantee schemes
- **USD significant weakness** could push the Fed to stop its APP and negatively impact the UST market, bring deflation into the EZ and Japan, and undermine the EM recovery
- **Sovereign debt crisis**
  - With public debt as a share of GDP reaching historically high levels in peacetime, most countries are vulnerable to rating downgrades and rising interest rates, in the event of policy errors
  - Emerging market fragilities (single commodity exporters tourism) could also face a balance of payments crisis and increase default risks

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

- Oil, risky assets, frontier markets and EM

(GEO)POLITICAL RISK 10%

- **US/China cold war**
  - In the wake of the US elections the hawkish tone from Democrats is bringing new policy uncertainties to the bilateral relationship
  - The delisting of Chinese companies might trigger similar retaliation
  - Possible accidental confrontations in the South China Sea or the Taiwan Strait
- **Instability within, and among, EM countries** on the back of chaotic virus crisis management
- **Brexit 2.0**
  - 2020 ended with an exit deal but implementation of it might prove to be a lot more disruptive than anticipated, leading to supply disruptions
  - In the context of a third national lockdown, the domestic political consensus around the Prime Minister might fade as the exit brings an immediate loss of income in several sectors
  - Scotland may ask for another independence referendum

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

- Oil, risky assets, EMBI

CROSS ASSET DISPATCH: Detecting markets turning points

How to the read turning point assessment

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

ECONOMIC BACKDROP

- The Covid-19 second wave led to the introduction of new lockdown measures across the EU, causing a renewed contraction in Q4 2020. Similarly, a deceleration in economic activity took place in Q4 in the US, as Covid-19 cases have surged to record highs.
- Soft and hard data confirm these trends, with the manufacturing sector holding up better than services as it is less disrupted by the latest restrictions.

FUNDAMENTALS & VALUATION

- Risky assets are trading at high levels, discounting solid growth expectations.
- Equities' absolute P/Es are still above their historical average, though they are expected to revert going forward as profits rebound.
- The equity risk premium and P/E adjusted for CB liquidity injections are still in favour of equities in relative value terms.

DEFENSIVE ASSET ALLOCATION

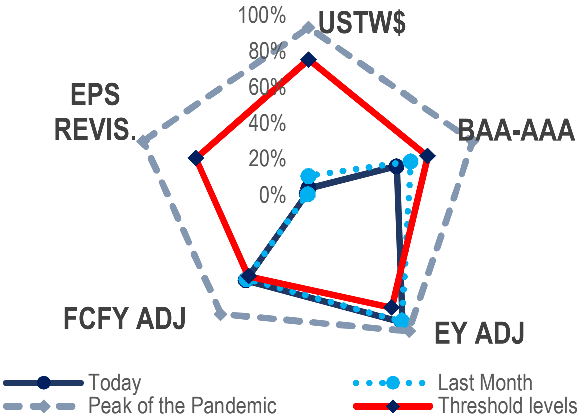
TECHNICALS

- We entered the last month of 2020 with all risky assets in overbought territory, driven by the outcome of the US election and positive Covid-19 vaccine developments which have been strong catalysts.
- Tighter restrictions over the Christmas period in many DM countries and some profit-taking before year-end reduced the momentum in risky assets. This points to a lack of clear-cut directionality when looking at trend following or pure contrarian signals. High yielders in fixed income (HY Corp US and Europe, GEM Bonds) are the most stretched segment at the cross asset level.

SENTIMENT

- With CBs reassuring the market about their support for the global recovery, financial conditions eased further in December, thus leading our risk-sentiment barometer to remain in support of risky assets for the beginning of 2021.
- The downward trend of the USD and improved perceptions about credit conditions (Moody's Baa-Aaa spread tightened further in December and is currently 10 bps below our alert level) are the key supports for our CAST indicator, which shows a limited probability of a sell-off (CAST OFF probability < 10%).
- Additional supports come from our flow-based risk indicator, suggesting that investor appetite remains high at cross asset levels (equities and commodities are the segments with a higher risk stance).

Cross Asset Sentinels Thresholds (CAST) still supportive



Source: Amundi Research, Data as of 22 December 2020

CAST flags extremely low risk perception.

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

<u>Methodology</u> 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 Hidden YCC by the ECB

- Technical factors will continue to play a major role in the euro fixed-income market.
- Unused PEPP + additional QE will more than cover 2021 net new issuance, due to higher deficits. The ECB will buy 70% of 2021 Gross Sovereign Supply.
- This is the end of Bund's volatility. Marketable on overall sovereign debt is lower for Germany than for other major European countries: 73% vs ratios between 83% and 87%. This is the first factor supporting Bund scarcity.
- The extended PEPP can be re-calibrated at any point in time. This is YCC (Yield Curve Control) without saying it.

2 How far the "great rotation" can go

- After the strong rally in risky assets, we see more opportunities in lagging sectors and styles, rather than in regional allocation.
- While Europe usually performs in line with US equities during a recovery phase, this unusual recovery favours European cyclicals and its financials. The same applies to Japan (Value and Growth) relative to the US.
- Value vs. Growth mean reversion is just starting and has room to expand further. The positive signal is that the correction of the valuation gap between the two is materializing, with Value catching up, and not through a burst of a Growth bubble, which is a positive signal for pro-cyclicality.
- Until bond yields are below the average nominal growth expectations over the course of the cycle, it will mainly be the speed of adjustment of the bond market that matters. Provided that CBs don't allow rates to move quickly, and corporate earnings growth keep rising, there is enough time for the rotation to play out.
- Georgia's Senate runoffs results should further boost the rotation out of USA into RoW, once markets digest the potential of higher tax and regulatory implications from a full Democratic government.

3 FX matters

- On the USD, the expectation of stronger growth in 2021, fueled by vaccine hopes, spurred risk sentiment and almost filled the undervaluation gap, while the Fed removed almost entirely the USD rates advantage that made the greenback a profitable opportunity on top of a defensive play.
- The ECB will also continue to monitor developments in the exchange rate. It's not the current level of the EUR but the pace of its appreciation looking ahead that is likely to worry the ECB (with a stronger pass-through to prices at a time when inflation is already in negative territory).
- Global determinants remain the key factor to watch. We see commodities performing in line with nominal GDP, a mild steepening of the curve and Value outperforming Growth: NOK, AUD, SEK and CAD show the highest risk /reward profiles. There's too little to squeeze from NZD, EUR and GBP.

4 EM equities as the recovery play

- EM Central banks remain accommodative, but the pace of yield compression is going to decelerate, and inflation is expected to normalize to higher levels.
- EM FX is still undervalued on average. We see +0.5% upside on a three-month horizon. The potential EM FX upside is higher in GBI-weighted terms (+0.8%). We remain positive on some Latam countries like MXN and PEN, as well as for IDR, RUB and some Asian FX, such as CNY, which are more advanced in the economic recovery and in controlling Covid.
- HC bonds show limited room for further spread compression in 2021 even if we expect lower volatility in 2021 compared with 2020. We still see more room in H12021 for HY. Our scenario for USD depreciation is not supportive.
- EM equity earnings growth is being driven by the rebound in world trade, emerging exports and a mild but positive increase in commodities prices. Profits growth in the first half of 2021 will be more concentrated in Emerging Asia, which is much more advanced in the recovery and more linked to booming e-commerce profits and the secular trend of technology. The region remains safer and should continue to outperform, involving laggards such as Indonesia. We see room in the next months for some rotation into laggards and value places like Mexico and Russia.

Covid-19 update by David Brecht, *Fixed Income Analyst, CFA*

As the rollout of approved vaccine is under way across the globe, two more vaccines from J&J and Novavax have near term chances of approval. If approved, the J&J vaccine would massively increase the supply with one billion dose targeted in 2021.

There is a lot of concern around two new variants of the coronavirus, one in the UK (B.1.1.7) and the other in South Africa (B.1.351). Both variants have mutations in the receptor-binding domain, which is where the virus binds to the host cell. Both variants are much more contagious, which just could be because a person exposed to the variant is more likely to get infected or because a person sick with this variant sheds and therefore spreads more virus. The South African variant also has some additional mutations that could negatively affect vaccine efficacy. These mutations are on the virus' spike protein, which is also the target of the vaccines and antibody therapies.

The UK variant does not appear more lethal but supports the hypothesis of Covid being endemic. Moreover, vaccines in development are all polyclonal and there is no evidence that any mutations so far make a vaccine ineffective. Vaccines can also be updated (6 weeks according to BioNTech) and most vaccines should continue to be effective.

AMUNDI ASSET CLASS VIEWS

	Asset Class	View	1M change	Rationale
EQUITY PLATFORM	US	=		The "blue wave", with the Democrats taking control of the Senate should further support the rotation towards value themes. It has to be monitored for the potential effects on taxation and legislation on big corporation. In addition, equities are attractive vs fixed income as earnings yields exceed corporate IG yields and the gap between dividend yields and the 10Y Treasury yield is huge. Looking ahead, economic recovery in 2021 and earnings improvement should be supportive. However, investors should be mindful of excessive valuations and should explore rotation towards quality Value and cyclical stocks as well as ESG themes.
EQUITY PLATFORM	Europe	=/+		We stay mildly optimistic as a vaccine rollout should support normalisation of the economy, but we believe a sustainable rotation favouring Value and cyclical depends on economic recovery, continuous fiscal push, and the direction of interest rates. However, investors should remain focused on businesses with potential for long-term earnings growth and resilient business models.
EQUITY PLATFORM	Japan	+		Pro-cyclical markets, such as Japan, with a large share of industrials and consumer discretionary sector, should benefit from an economic rebound as well as from close trade linkages with China. In general, the high operating leverage of businesses in Japan should be positive for profit margins as a result of higher sales in 2021.
EQUITY PLATFORM	Emerging markets	+		We remain constructive in light of a potential large-scale vaccine availability and as investors put more money to work away from low remunerating assets. Asia is our favourite area, but the improvement in economic conditions should support Latam and Cemea next year as well.
FIXED INCOME PLATFORM	US govies	=		In global portfolios, we are close to neutral on USTs, but are actively monitoring the direction of rates and curve movements in light of fiscal stimulus discussions and expectations of curve steepening. Instead, we prefer TIPS. With a US fixed income perspective, USTs offer good liquidity, but could come under pressure as the growth outlook improves. So, we are cautious.
FIXED INCOME PLATFORM	US IG Corporate	=		We remain neutral/marginally positive amid Fed support for the markets, but acknowledge that IG spreads have tightened. In securitised credit, consumer and housing markets present selective opportunities as US consumer and savings remains strong and loan/value ratios are low.
FIXED INCOME PLATFORM	US HY Corporate	=		HY offers that extra income in a low rate world supported by Fed action, but we are very selective in view of default risks and a slow recovery. Going forward, investors should differentiate between companies that have the capacity to repay their obligations vs those that are being helped by artificially low borrowing rates.
FIXED INCOME PLATFORM	European govies	-/=		We stay cautious on core Euro government bonds due to overvaluation and see limited risk of yields dropping further, although the ECB will maintain its supportive policies, as highlighted in its latest round of stimulus. However, we are positive on peripheral debt, mainly through Italy, amid a strong EU policy response, even though we think prospects of spread compression in this space are now limited.
FIXED INCOME PLATFORM	Euro IG Corporate	=/+		Euro IG offers opportunities in the 'search for yield', particularly in the BBB segment. The scope for further spread compression is limited, and investors should lock in gains where the potential for further tightening is limited. A focus on quality and liquidity must be maintained.
FIXED INCOME PLATFORM	Euro HY Corporate	=		Spread tightening will not be uniform across the board. Instead, the case for selectivity is as key as ever and investors should use research as a means of balancing yield with quality and should steer clear of very-low-quality names.
FIXED INCOME PLATFORM	EM Bonds HC	=/+		We keep our benign outlook for EM debt, but continue to see better risk/reward in HY, and while spreads are tighter, there is still room for compression. We stay mindful of the potential risk on the duration side in IG, if there is further pressure on USTs.
FIXED INCOME PLATFORM	EM Bonds LC	+		We are positive on LC bonds because of expectations of USD weakness. On FX, a global low-yield environment, benign inflation, stable US policy, and an early-cycle growth environment all support EM local currencies.
OTHER	Commodities			Oil prices moved up over the past month, reinforcing our conviction about a global economic recovery and an ongoing rotation. Nonetheless, we confirm our 2021 price target range of US$40-50/bbl for WTI. We also reiterate our constructive view on gold, despite the recent correction. Gold will benefit from a prolonged dovish stance of central banks.
OTHER	Currencies			Despite most of the G10 FX undervaluation gap (vs the USD) has been absorbed, a shift from 'Contraction to Recovery' suggests that the greenback has more room to correct lower, at least in 1H21. In addition, our central scenarioof a global recovery sees commodities performing in line with nominal GDP, a mild steepening of the yield curve, and Value outperforming Growth. All of these factors are likely to weigh on the dollar, which is still about 3% above its average fair valuation. In this environment, the NOK, AUD, SEK and CAD show the highest risk/reward profiles.

LEGEND

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	Negative		Neutral		Positive		Downgrade vs previous month	Upgraded vs previous month

Source: Amundi 21 December 2020, 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

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