Research

#06
June
2021

CROSS ASSET
Investment Strategy

CIO VIEWS

The inflation moment

THIS MONTH'S TOPIC

First quarter 2021 results: a far better-than-expected rebound that augurs well for the full year

Confidence must be earned

Amundi
ASSET MANAGEMENT

#06 - June 2021

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CIO VIEWS

The inflation moment

Pascal BLANQUÉ,
Group Chief Investment Officer

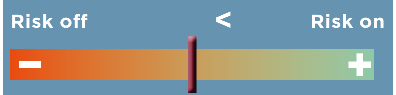
Vincent MORTIER,
Deputy Group Chief Investment Officer

Inflation has remained dormant for a long time, with years of below-target and weak inflation, but we are now reaching a delicate juncture where inflation is taking the driver's seat in financial markets. **Whether this is just temporary or will prove persistent is the crucial question and at present there are two conflicting inflation narratives.** A series of voices claim that inflation is just temporary. In contrast, others warn about the possibility that inflation will turn structurally higher than initially thought because of economic growth, upward pressure on wages, a fiscal push, strong consumer demand and rising supply constraints (commodity side). **In the end, something structural is just something temporary that has lasted. We think it is unlikely inflation will pick up only for a few months and then return quickly to about 2%**. Rather, we think this is the start of a journey towards a mid- to long-term period of higher inflation and lower growth compared to the current consensus. For the Fed, there is limited room for policy mistakes as the loss of control of the yield curve is a rising risk at this stage. We outline our convictions below:

- **Tactically reduce risk, moving from moderately long to neutral**. We have entered an uncertain and riskier environment – volatility is rising and the equity-bond correlation is turning positive. We believe it is important to remain cautious and lock in some gains in risk assets. Taking a strategic view, some exposure to equities is warranted against a backdrop of higher inflation and inflation volatility. In equities, investors should seek some protection against the bursting of the tech bubble. This means being cautious on interest rate sensitive stocks, while preferring dividend yielding stocks and real asset exposed stocks. Equities will do OK in absolute terms as long as inflation is not breaking the anchored territory. Nevertheless, the risk-adjusted performances of a balanced portfolio will be challenged by the changes in the equity-bond correlation (turning positive). Investors should favour shorter duration assets, fixed income and FX carry, equity cash flow yield, real estate, value and the low volatility factor.
- **Equities: seek a barbell approach, favouring cyclical quality value** on one side and defensives on the other. In tactically moving to a more neutral stance on equities, investors should keep a value/cyclical preference vs. growth, while also balancing this with some defensive positioning. As mentioned earlier, the market is due for a pause, during which we believe it would be wise to move to neutrality in equities, including in more cyclical markets such as emerging markets and Europe. Most importantly, this market pause could help further clean up some excesses in the market and will continue to support the rotation from growth to value.
- **Bonds: stick to short, active duration and moderately long credit.** This means reducing duration, in particular in the US, and waiting for better entry points. Investors should be agile in playing duration at this stage as phases of undershooting and overshooting can offer tactical opportunities. Yet while reducing some of their short stance when the time comes, investors should resist the temptation to go long duration. For the coming years, the direction of rates is up. This will not be a straight journey, but the trend is there. This means that in FI, investors should look at opportunities at curve levels, where we continue to expect the US curve to steepen, and at opportunities in short duration higher yielding assets such as HY and EM bonds with a short duration bias.
- **EM: facing the threat of vulnerability, China and Asia in focus**. EM are also due to be under pressure amid rising yields. On the dollar side, the mid-term trend is downward as the Fed balance sheet and the US fiscal budget dynamics are the dominant factors. However, short-term challenges remain in an emerging world still characterised by the vulnerability factor, with retreating global trade and rising inflation. China and some Asian countries will be the winners and their currencies will be the critical channel to adjust relative prices in the new regime. The Renminbi will be the Deutschmark of the region, leading to a fast-rising status of cash and government bonds in Renminbi in global portfolios as a store of value given their positive real returns.

Looking ahead, markets will have to walk the inflation journey. We are approaching the end of the first leg, characterised by strong rotations, on the road to the peak. We will soon be entering leg two, the peak phase. This is still relatively positive for investors as inflation is not seen as a threat to growth but a complement to reviving economies, but the more we advance into this phase, the higher the risk of nasty surprises. The next leg will be about what is left of the peak (most likely not the Goldilocks regime markets are currently pricing in).

Overall risk sentiment



Neutral on risk assets to lock in gains in a more uncertain environment amid inflation risk.

Changes vs. previous month

- Reduce risk to neutral in equities.
- More cautious on US duration and neutral on EM FI in cross-asset.

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

MACRO

Copper: demand/supply imbalance and price impact

Monica DEFEND,
Global Head of Research

Lorenzo PORTELLI,
Head of Cross Asset Research

The potential demand boost from strong fiscal stimulus and the transition towards greener economies, together with the still concentrated production, should support copper prices in the long term

Rising global demand and sluggish country- specific production is the most relevant long-term imbalance in the copper market. The long- term picture and expectations on the global shift to a green economy will lead to a structural shortage and a significantly higher price for copper ($18,000-$20,000/metric tonne), even without above-average economic growth and just assuming a reversion to a more sustainable growth path.

After several years of oversupply of industrial raw materials, we expect pressures on demand in this market due to multiple factors – the new fiscal packages focusing on infrastructural plans and tied to the green agenda have accelerated across the globe, whereas supply, or in general, production, has lagged because of the pandemic and lockdown restrictions in major exporting countries.

Demand for copper is set to grow by 2% per annum for the next 20 years as it is a necessary metal for the green transition. However, production will struggle to keep up with this demand. This is because production is still concentrated in a few countries, exposing the market to bottlenecks and shortages, as happened recently. Almost 50% of production is from four countries: Chile, Peru, Republic of the Congo and Zambia. Overall production could be affected by idiosyncratic risks and capital expenditures mechanisms that are not fully integrated.

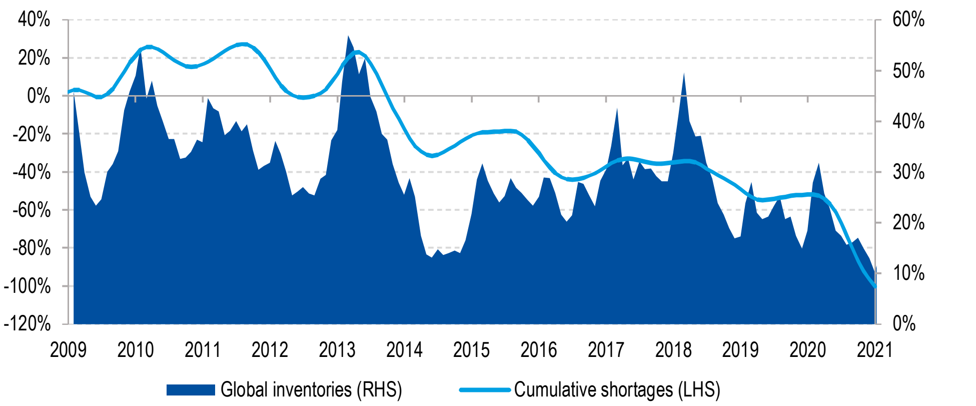
On the other hand, demand is concentrated mainly in China, Asia and those Western developed countries that are most committed to the green economy transition, with systemic long-term shifts rather than isolated temporary programmes. The big wave in shortages and declining inventories began in 2013 when China started to boost its transition to a more balanced and greener growth model. However, more recently, since 2020 shortages have been exacerbated by the pandemic and lockdowns impacting mining activity in Latin America.

The most acute phase of shortages related to the pandemic was noticed in January 2021, when the global inventories/demand ratio moved below 10%, although recent months have shown signs of a rebalancing in the inventory cycle. As the recent shortages have been mostly related to lagged production caused by extraordinary events that should prove temporary (the Brazilian Covid variant spreading to Chile and Peru, and strikes in Chile), some relief in the commodity price rally is likely in the near term.

In the long run, however, the risk premium should be significantly positive. Over the past five years, the narratives behind copper have been dominated by lacklustre absolute economic growth concerns. In fact, there was a general underestimation of the impact of the secular shift to new growth engines (mainly in GEM), with potential long-lasting repercussions on involved production factors. Now, the narrative is shifting towards the green transition and the price adjusted for shortage/ inventories will move higher.

Industry projections call for a multi-year shortage, with a recalibration in the base metals universe. This imbalance will increase the pressure, not only on inflation and growth, but also on finding new technologies to achieve fully green economic growth. **From an investor perspective, it will provide a meaningful positive risk premium to base metals over other risky assets.**

Global copper inventories and shortages



Source: Amundi Research, Bloomberg, as of 31 January 2021. Cumulative shortages = cumulative production/demand, Global inventories = inventories/demand

MULTI-ASSET

Risk-neutral for now, play relative value

Matteo GERMANO,
Head of Multi-Asset

We believe the current pause in momentum is not a call for any structural de-risking, but rather a way for investors to assess where we are at the moment, preserve the good performance so far and look for attractive entry points in future

The US and Europe are expected to deliver strong growth this year, allowing us to stay within the overall pro-risk paradigm from a medium-term perspective. However, we mentioned last month the importance of remaining vigilant on soft and hard data, which had been showing a pause in economic momentum. Now, we confirm a mild weakening of sentiment and rising inflation numbers, with the bar for positive surprises set much higher. As a result, **we recommend investors tactically reduce risk to neutral, and look for entry points later, when valuations are more appealing. Investors should adopt a total-return, agile approach** that protects returns from inflation, in an overall recovery view for the year.

High conviction ideas

We have moved to a neutral stance on equities, tactically shifting from a constructive stance on Europe and EM to neutral. **This is not a call for any long term de-risking** but a way for us to see how valuations are affected by rising input prices (profit margins) and upward pressures on US rates, as well as how earnings expectations evolve after a period where markets have become complacent. On EM equities, the risk of an inflation surprise and dollar strengthening present major headwinds, at least in the short term. However, we remain slightly positive on China through the Hong Kong route.

On the other hand, we are now defensive on US duration and neutral on Europe, as the unprecedented economic growth revisions in the US could put upward pressure on US Treasury yields in the medium term, although we believe the upward path will be slower than the one seen in Q1. Hence, the need to stay active is high.

We maintain our reflationary view as we stay positive on US inflation and UK yield curve steepening (2-10y) on the back of the progress on vaccines and the economy's reopening. Euro peripheral debt, especially 30y Italy vs. the German spread, continues to offer attractive yields amid strong fundamentals and technicals. The global economic backdrop and our expectations of recoveries and reopenings allow us to be constructive on corporate credit, both EUR IG and HY, amid supportive fundamentals. IG should benefit from ECB bond buying, whereas the improving default rate outlook paints a positive picture for HY, but selectivity is important. Overall, risk sentiment is turning more supportive on the asset class.

EM debt is an instrument to boost portfolio income in the long term. However, for the time being, we move to neutral owing to EM debt reaching fair value. In addition, there are concerns over rates rising in the US and the diminishing EM-DM growth differential, as well as the slower vaccine roll-out and weak fiscal positions (ballooning debt/GDP ratio) of some EM.

FX is a key way for investors to play the relative value and reflation story but they should be prepared to selectively adjust their stance. For instance, we are no longer positive on MXN/USD due to increasing domestic risks in Mexico and its less appealing economic fundamentals. However, we are positive on the carry basket through the RUB vs. EUR and BRL vs. JPY, and in Asia, we remain constructive on KRW/EUR (the semiconductor cycle) and CNH/EUR, due to the increasing role of China in intra-Asian trade.

In DM, we have upgraded the USD/JPY to positive as the dollar is likely to be supported in the short term by upside pressure on yields, whereas the yen will be weighed down by relatively weak Japanese growth. We have kept our reflationary FX trades basket through CAD/USD and NOK/EUR, but stay cautious on CHF vs. the GBP and the CAD.

Risks and hedging

While renewed US-China tensions should prove transitory, any disappointment on this front could lead to higher volatility. In addition, we also see some risks in the UK related to pro-independence parties in Scotland. As a result, investors should maintain appropriate hedges to protect their IG credit and US rates exposure through derivatives.

Amundi Cross Asset Convictions

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

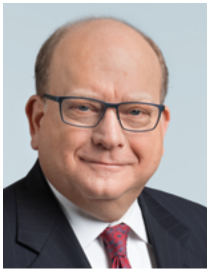
Source: Amundi. The table represents a cross-asset assessment on a three- to six-month horizon based on views expressed at the most recent global investment committee. The outlook, changes in outlook and opinions on the asset class assessment reflect the expected direction (+/-) and the strength of the conviction (+/++/+++). This assessment is subject to change.
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

A story of growth, inflation and real rates

Éric BRARD,
Head of Fixed Income

Yerlan SYZDYKOV,
Global Head of Emerging Markets



Kenneth J. TAUBES,
CIO of US Investment Management

Although inflation expectations have been rising, real rates are still negative. Investors should monitor how economic growth affects nominal and real yields and maintain an active view on duration

The global economic recovery is gaining momentum, but it is also flaring up a debate on inflation, particularly in the US. Despite the recent overshoot of inflation, the Fed is likely to downplay the risk. However, both consumer and producer prices are rising, and when we look at PMI data, it indicates that price pressures have been with us for some time now. Therefore, amid the risk of policy mistakes, there is a strong need to remain cautious and flexible on duration, while the backdrop remains positive for credit.

Global and European fixed income

We have slightly increased our defensive stance on US duration, but remain active across the yield curve to monitor rates movements. On core euro, we maintain our cautious view in light of curve steepening expectations, but are constructive on peripheral debt. The latter offers attractive yields and should be well supported by the ECB. We are also optimistic on Chinese and Australian duration. We confirm our positive view on inflation in the US and Europe, but investors should look to diversify this strategy through breakevens in Australia.

In credit, we are evaluating the ESG angles, US infra plan and economic rebound. The last is also improving corporate fundamentals, leading to a better default outlook. In addition, investors should adjust their portfolios to account for the risk of rising rates that comes with inflation by reducing duration risk and increasing spreads and shorter-duration debt, so that the overall credit beta remains constant. Overall, we favour financial subordinated debt and cyclical sectors (energy, auto) linked to the rebound. In EUR IG, we prefer BBBs and in HY we look for further spread compression, although we aim to balance carry with quality.

US fixed income

President Biden's fiscal spending will give a strong boost to growth. On the other hand, strong demand, supply shortages and lower inventories are likely to push inflation up. As a result, USTs will come under further pressure, causing curve steepening. **We remain cautious but active on duration and are monitoring the movement of nominal yields, inflation and real rates**. TIPS remain well supported. Robust consumer earnings and savings allow us to be positive on the consumer, residential mortgage and securitised credit markets, but we are selective. Being valuation conscious is extremely important, especially in non-agency and CRE, at a stage when liquidity is abundant. Finally, we are positive on corporate credit but avoid volatile names that have rallied. Upward pressure on core yields and inflation requires us to be careful about interest rate and duration risks. We recommend limiting long duration in IG and prefer shorter-duration debt. HY offers better carry but selection is crucial.

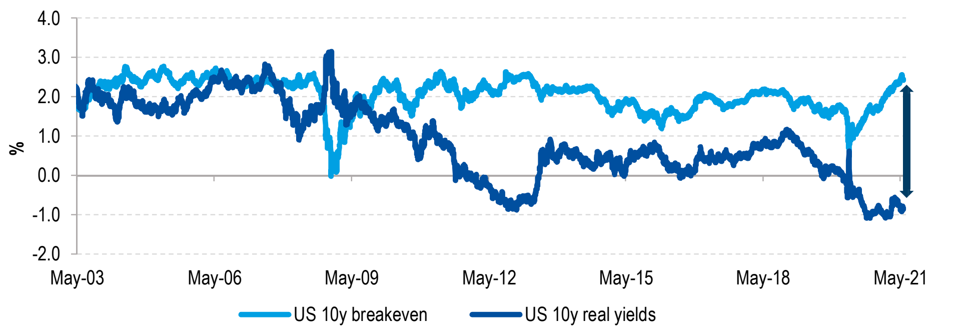
EM bonds

Slow vaccination programmes, the pandemic's resurgence and rising US rates lead us to be cautious on EM FI in the near term. We are defensive on duration and are prudent on local rates, with a short-duration bias. On HC, sovereign spreads have shown resilience amid higher US yields, but IG remains expensive at the current level and HY is more fairly valued.

FX

We have further upgraded our positive view on the USD in light of the country's strong economic recovery, which should push US yields upwards. However, we have downgraded the GBP/EUR on potential pressures from a Scottish referendum.

US 10y real rates and breakeven rate



Source: Amundi, Bloomberg, as of 17 May 2021. USGGBE10 Index, H15X10YR Index

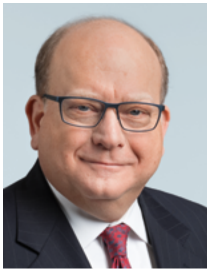
GFI = global fixed income, GEMs/EM FX = global emerging markets foreign exchange, HY = high yield, IG = investment grade, EUR = euro, UST = US Treasuries, RMBS = residential mortgage-backed securities, ABS = asset-backed securities, HC = hard currency, LC = local currency, CRE = commercial real estate,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

EQUITY

Cyclicals, value rotation will not be a straight line

Kasper ELMGREEN,
Head of Equities

Yerlan SYZDYKOV,
Global Head of Emerging Markets



Kenneth J. TAUBES,
CIO of US Investment Management

Overall assessment

The vaccine roll-out across the developing world is progressing and economies are reopening. However, markets seem to be pricing in a Goldilocks scenario where future earnings growth will be strong enough to compensate for the rising input prices. This means inflation pressures are likely to be passed on to consumers. But if growth disappoints – not our base scenario – valuations could be affected. All this signals that investors should maintain a balanced stance, with a bias towards normalisation. But what it also indicates is that not all boats will rise with the expected recovery. A **bottom-up fundamental analysis should help investors identify non-disrupted businesses and those with strong balance sheets**, particularly in the cyclical and value areas.

European equities

We believe while European earnings revisions have been very strong, market's reaction suggests a lot of the good news has already been priced in. **As a result, stock selection and identifying names with pricing power is important**. Not surprisingly, the way in which European sectors are composed means cyclical and value areas suffered the most during the crisis, when economic growth was weak. However, this also means that when economic growth returns this year, these areas should do well as the rotation has much more room to go. At a sector level, we are more constructive on industrials and keep our bias towards financials (earnings potential, benign asset quality, positive flip from rising rates). On the other end, we hold quality defensive names (telecoms), which are becoming increasingly attractive and provide strong cash flow yield. We are cautious in areas such as technology (interest rate sensitivity) and have increased our bias against discretionary, where valuations do not reflect fundamentals.

US equities

When inflation expectations are overshooting and valuations are high, earnings growth, reopenings and leadership rotations will drive markets. Already, earnings and the future prospects for cyclical and value have displayed a robust trend, convincing us to maintain our positive stance on these areas. But it also signals that stock selection will be even more important as valuations are becoming full. Importantly, value stocks also provide a hedge against inflation, with sectors such as financials, energy and materials at the core of this trend. For some growth names most of the good news has already been priced in, confirming our cautious stance (high momentum, high growth). Although technology is not attractive on a relative valuation basis, there are some positive and compelling secular trends to consider.

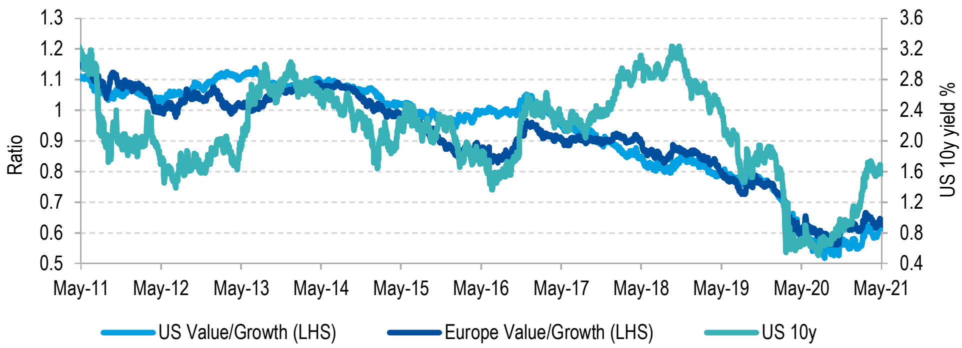
On the other hand, expectations of higher rates (cost of capital) lead us to believe that defensive segments are not cheap, with the exception of healthcare. This is because the expected reforms for the sector are likely already priced in. But only those names with a strong innovation culture will be able to provide sustainable returns.

EM equities

Valuations are supported by economic recoveries and earnings improvements. However, geopolitical and idiosyncratic risks (Russia/Ukraine, LatAm protests, Asia regional tensions) need to be monitored. We favour value/cyclical stocks over growth amid expectations of a recovery. At a sector level, we are more positive on discretionary due to reopenings but less so on technology. On the other hand, we are more cautious on healthcare due to elevated valuations and remain defensive on consumer staples and Chinese financials.

In an inflationary environment, investors should focus on companies with high margins and strong pricing power displayed through brands and intellectual property

Rotation favouring value will persist, but won't be linear



Source: Amundi, Bloomberg, data as of 19 May 2021. Russell 1000 Value, Russell 1000 Growth, MSCI Europe Value, MSCI Europe Growth.

THEMATIC GLOBAL VIEWS

What if the Democrats succeed in passing the capital gains tax?

Since Joe Biden's elections, most observers have been surprised by how Democrats managed to pass significant fiscal policies despite their thin majority. We believe the capital gains tax hike could go ahead regardless of the Republicans opposition. The impact of previous tax hikes on markets over the short and long run is not clear. However combined with slowing economic momentum and fears around Fed tightening, this might be a short-term headwind for US equities in Q4 2021.

Didier BOROWSKI,
Head of Global Views

Pierre BLANCHET,
Head of Investment Intelligence

Democrats are not looking for a compromise with the Republicans

When Joe Biden was elected last November, the Democrats did not have a majority in the Senate. The consensus then was that the new administration would seek a compromise with the Republicans on fiscal policy. Gaining a majority in the Senate in early January did not change the conviction of observers. The Democratic majority was seen as too narrow to pass all the electoral promises. This is all the more true since some centrist Democratic lawmakers openly opposed some promises.

It was therefore not without surprise that the Biden administration managed to pass a $1.9 trillion stimulus package without compromise, when most observers expected a $1.1 trillion to $1.3 trillion package. The only thing the Democrats had to give up was a measure to raise the federal minimum wage, because the reconciliation procedure could not be used to pass a measure that did not directly affect the budget.

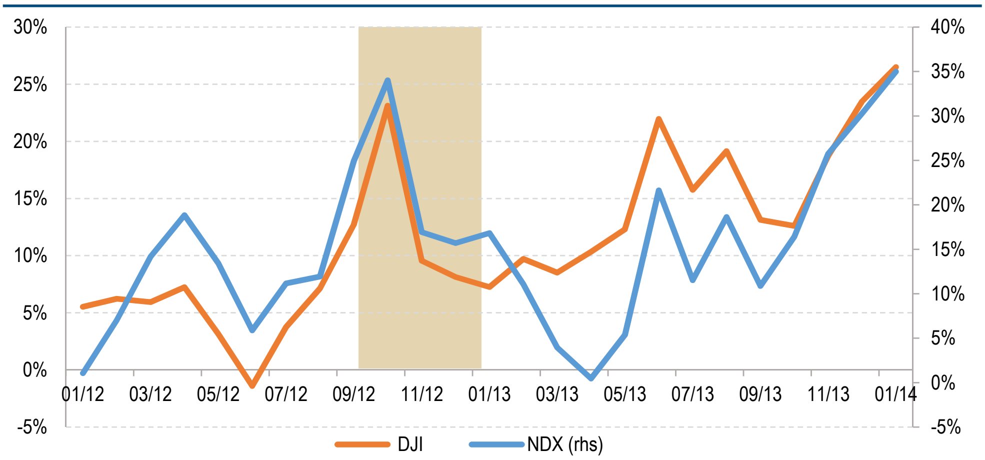
Shortly afterwards, Joe Biden presented his infrastructure investment plan ("American Jobs Plan"), which includes many of his presidential campaign commitments. Amounting to nearly $2,250bn over 8 years, this plan would be financed by an increase in corporate taxes of an equivalent amount but over a period of 15 years. Joe Biden then presented the second part of his recovery plan, with $1,800bn in new social spending over 10 years, financed by tax increases on the wealthiest households. At the same time, the administration wants to eliminate tax breaks for private equity fund managers[1]. Finally, Joe Biden signed an executive order to increase the minimum hourly wage from $10.95 to $15.00 in companies with federal government contracts.

As a matter of fact, the Democrats are not concerned about finding a compromise with the Republicans, who are naturally very much opposed to all these projects, especially those on taxation.

The results of the latest census show that political power is shifting from the Midwest and Northeast to the South and West. The new state population figures will be used to reallocate seats in Congress and the Electoral College. We think this will strengthen the Democrats in their strategy. According to our calculations, Democratic-dominated states will lose three seats in the House of Representatives in 2022, while Republican-dominated states will

[1] *In addition to wages, these managers rely mainly on a share of asset appreciation (known as carried interest). These profits are currently taxed as capital gains, at a rate well below the top marginal income tax rate applied to wages. The Biden plan would remove this tax break.*

1/ **Dow Jones Industrial (DJI) and Nasdaq100 (NDX) performance (YoY %, monthly, Jan 12 to Jan 14)**



Source: Amundi Research - Data as of 25 May 2021

THEMATIC GLOBAL VIEWS

The census show that political power is shifting

The capital gains tax could negatively impact stocks with a strong price momentum

gain three. This means that the Democrats could loose control of the House with this new split in November 2022. This is a real wake-up call for Democrats.

The census should therefore encourage them to keep their electoral promises in order to consolidate their electoral base. One of the most emblematic measures **is the increase in the capital gains tax**, which has strong distributional effects. Against this backdrop, we believe, unlike most observers, that this measure is likely to be passed by the end of the year.

Could the capital gains tax hurt the US stock market?

There have been four capital gains tax increases in the US in recent history: 1969, 1976, 1987 and 2013. The 1976 hike was limited to less than 4% whereas the other three were close to 9%, i.e. comparable to the current hike being discussed by the Democrats. 1969 was more than 50 years ago, a time when the US household savings rate was nearly 10% compared with 2.5% today and US equities were in a bear market. Therefore, the comparison with today's situation might not be so relevant. But we can still use 1987 and 2013 as reference points.

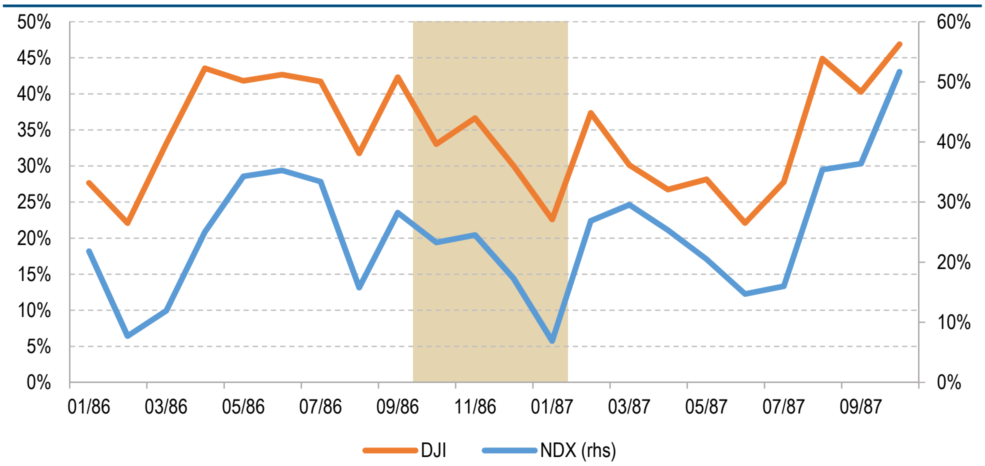
When looking at the performance of the Dow Jones Industrial Average (DJI) and the Nasdaq100 (NDX), we can see an inflexion point three months before the capital gains tax implementation date, which could be linked (among other factors) to investors taking profits before the introduction of the new tax rate. The NDX lost 5% in the last three months of 2012 and the DJI lost 2%. A similar situation happened prior to the 1987 capital gains tax hike, where the NDX and the DJI both lost their positive price momentum in the last three months of 1986, although they maintained a small positive return. Yet, in 2013 and 1987, both indices recovered quickly and showed positive performances in the first half of the year. Therefore, assuming the tax hike was the main factor behind these performance changes, it was only a one-off with short-term effects.

Assuming that the same profit-taking behaviour will apply again this time if the new hike is implemented on 1 January 2022, the US equity market could face headwinds from October to December 2021. Private investors might then rebuild their positions over the first quarter. Going forward, we should assume the impact will be marginal. Indeed, three years after the 1987 and 2013 hikes, the DJI and NDX were both up by between 30% and 76%. Therefore, we cannot conclude that the tax hike had a big impact on that measure alone. However, when combined with slowing economic momentum and fears around Fed tightening, it may be the case.

An analysis of single stock performance around the 2013 capital gains tax hike (using the constituents of the Dow Jones industrial Index) shows that some of the outperformers in 2012 registered a pull-back from October until the year-end. However, there are several counter examples. Looking at stock returns over 1, 3, 5 and 10 years prior to the event, out of the 17 stocks that had a positive performance across <u>all time horizons</u> i.e. stocks with the highest probability of large cumulative gains, only nine had a negative performance in the last 3 months of the year. This includes names like Apple, McDonalds, Wall Mart and Disney, with no specific sector bias. 50% is not enough to formulate a rule, yet it is worth noting that most stocks showing a poor performance prior to the tax hike outperformed the index during the three-month period. We shall therefore assume there is some impact.

An increase in the capital gains tax may have an impact on stocks or sectors of the US market that have had very strong

2/ **Dow Jones Industrial (DJI) and Nasdaq100 (NDX) performance (YoY%, weekly, Jan 86 to Oct 87)**



Source: Amundi Research - Data as of 25 May 2021 performances in recent years. The effect could be more significant at the individual stock level than at the index level. Names like Tesla or Apple, for instance, could suffer, but the impact should be limited and short-lived. If history repeats itself, there is no evidence that the hike could have a long-term negative impact on the US stock market.

A problem might actually occur elsewhere. The capital gains tax will be limited to those earning income above $1 million a year, i.e. 0.7% of US households. These investors have access to the stock market of course but also to a broad range of investment products, such as private equity and alternative investment funds. The strong performance of sovereign bonds and credit might also be part of the equation and the capital gains tax could trigger outflows from the equity markets.

Finalised on 25 May 2021

THIS MONTH'S TOPIC

First quarter 2021 results: a far better-than-expected rebound that augurs well for the full year

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Éric MIJOT,
Head of Developed Markets Strategy Research

Ibra WANE,
Senior Equity Research Strategist

Corporate results rebounded in Q1 2021 to a surprising extent everywhere and are likely to continue doing so beyond 2021. This could mean a new, earnings-driven phase in the equity market rally. In the shorter term, however, the markets could be tentative in the wake of their strong gains, but probably without casting any doubt on their favourable outlook nine to 12 months out, particularly regarding value stocks.

Corporate results rebounded to a surprising extent everywhere in Q1 and are likely to continue doing so beyond 2021. In the medium term, a new phase in the equity markets rally is looming – less strong but based more on fundamentals, in which earnings growth would play a more decisive role. In the shorter term, however, many flags of a recovery are nearing their peaks, and the markets could become more tentative in the wake of their strong gains, but probably without casting any doubt on their favourable outlook nine to 12 months out. Amidst a likely generalised reopening, it is probably worth sticking to a rather pro-cyclical bias, particularly with regards to value stocks. Likewise, stock-picking will become increasingly decisive. In short, alpha is likely to take over from beta.

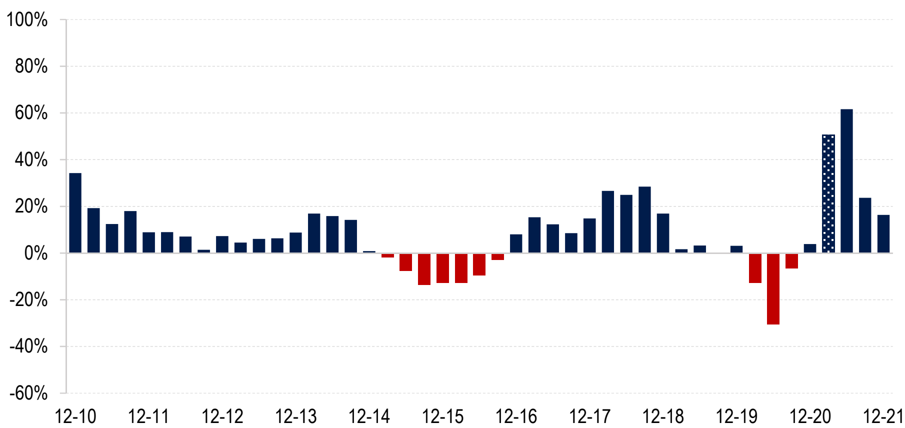
S&P 500: An impressive Q1 on both top and bottom lines!

As of 14 May, 91% of S&P 500 companies had reported. Reporting companies beat forecasts by far. In revenue terms, first of all, after declining by 1% last year, they soared by +13% in Q1 2021, far ahead of the +9% forecast as of 1 April, i.e., at the start of reporting season. Likewise, earnings skyrocketed by +51% in Q1, much higher than the +16% the consensus was forecasting in early January and the +24% it was looking at on 1 April. This is all the more impressive as Q1 2020 results (-13%) had not yet borne the full brunt of the Covid-19 impact. So Q1 results are not only better than last year's but 31% higher than the pre-Covid results of Q1 2019. Given that the US economy has just returned to its pre-Covid levels, the strength of the S&P's Q1 2021 rebound in revenues (+13%) and earnings (+51%) is therefore simply astounding.

That being said, trends varied widely from one sector to another. Financials and consumer discretionaries, for example, not only stood out, soaring, respectively, by +138% and +191%, they also fared better than had been expected in early April (+69% and +99%, respectively). Conversely, and unsurprisingly, utilities (-1%), real estate (+6%) and consumer staples (+7%) brought up the rear. More surprisingly, healthcare, a defensive sector, again rose very strongly in Q1 2021 (+27%), on top of its strong performance last year (+7%). Industry, however, disappointed. Cyclicals, whose results had dropped in Q1 2020 (-33%) had not yet managed to take off again in Q1 2021 (+1%).

Lastly, the famous GAFAMs once again put on a display. Taken together, results of Google (+166%), Apple (+119%), Facebook (+93%), Amazon (+215%) and Microsoft (+39%) more than doubled (+104%), whereas the consensus was forecasting less than half that just before results were

1/ **S&P 500 quarterly results (YoY, %)**



Source: Refinitiv IBES data, Amundi Research, Data as of 14 May 2021

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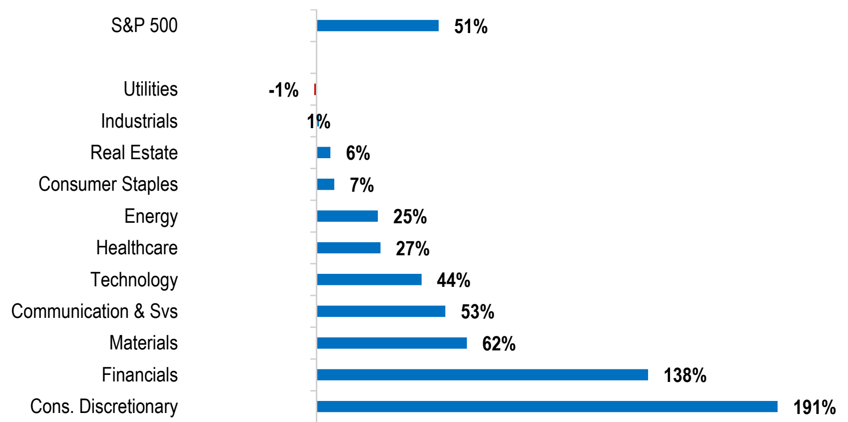
released (+48%). Even so, the market was less than impressed. While Google and Facebook performed well, GAFAMs had underperformed on average by 1% two weeks after their reporting dates. Indeed, between the generalisation of the economic recovery and the upward pressure on interest rates, enthusiasm for growth and quality stocks has receded and could shift over to cyclicals, value stocks and financials.

As a result of this excellent first quarter, the full-year S&P 500 consensus was raised from +26% to +35%. Because of base effects and the respective weights of the various quarters, this assumes increases of +61% in Q2, +24% in Q3 and +16% in Q4. Given the strength of the US recovery and the upcoming stimulus packages, these forecasts are likely not only to be reached but probably exceeded, barring any change in tax rates[1].

As a result of this excellent Q1, the full-year S&P 500 EPS consensus was raised from +26 to +35%

[1] *The Biden administration plans to raise the corporate tax rate from 21% to 28%, vs. 35% prior to the Trump reform, and to impose a minimum rate of 15%. The consensus expects this to lower the S&P 500's aggregate EPS by about 5-7%. However, there is still some uncertainty over the exact tenor of these reforms, and their effective date could be postponed to 2022 or even later.*

2/ S&P 500: Q1 2021 earnings (% chge YoY)



Source: Refinitiv IBES data, Amundi Research, Data as of 14 May 2021

Stoxx 600: a very robust rebound in Q1 results but so far due mainly to the receding in risks and to cost-cutting

Defensives which had stood out early in the pandemic are last in line this year

Reporting season is also almost over in Europe, where 81% of Stoxx 600 companies had reported by 18 May. As in the United States, the rebound was surprisingly strong, at +93% in Q1, almost double what was being forecast at the start of reporting season (+47% on 1 April) and far ahead of forecasts being put out just three weeks ago (+71% on 27 April).

However, and unlike the US S&P 500, Stoxx 600 revenues were almost flat (+3% vs. +13%). As the starting point in this area in Q1 2020 is relatively near (-3% for the Stoxx 600 and -1% for the S&P), this is revealing of the widening gap between the two regions on both the macro (stimulus, lockdowns, vaccination, etc.) and microeconomic (sector weightings, pricing power, etc.) levels. Likewise, this suggests that the take-off in company results in Europe is, for the moment, due more to cost-cutting and lower risk provisions than to true leverage on sales.

By sector and generally speaking, defensives, which had stood out early in the pandemic, such as healthcare and utilities, are last in line this year. Conversely, cyclical sectors, which had been hit the worst last year, are those that have rebounded the most this time, including consumer discretionary, energy, financials and industrials. Lastly, basic materials, which were driven initially by Chinese demand and, then gradually, by the reopening of other economies, are the only sector that has managed to fare better than average in both Q1 2020 and Q1 2021.

In light of base effects and the improvement in the health and economic environment, Stoxx 600 results should continue to improve and rebound strongly on a full-year basis, at +45%, according to the IBES consensus, including +93% in Q2, +32% in Q3 and +27% in Q4. Between the belated roll-out of vaccinations in Europe and the extension of lockdowns, the take-off expected for Q2 could be postponed in part to the second half of 2021 and early 2022. Be that as it may, although the acceleration of European economies is likely to be postponed by a few months, it is likely to happen eventually. That's why at this stage of the cycle, rather than growth stocks, defensives or large caps, it is worth overweighting value stocks, cyclicals and SMIDs.

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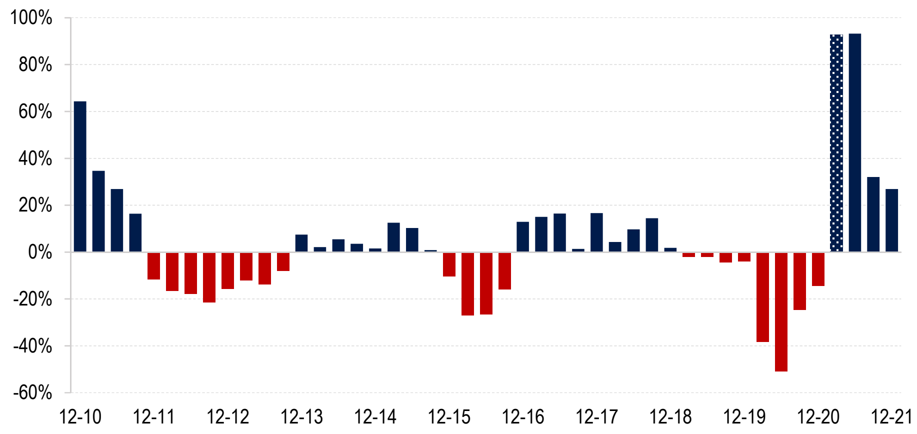
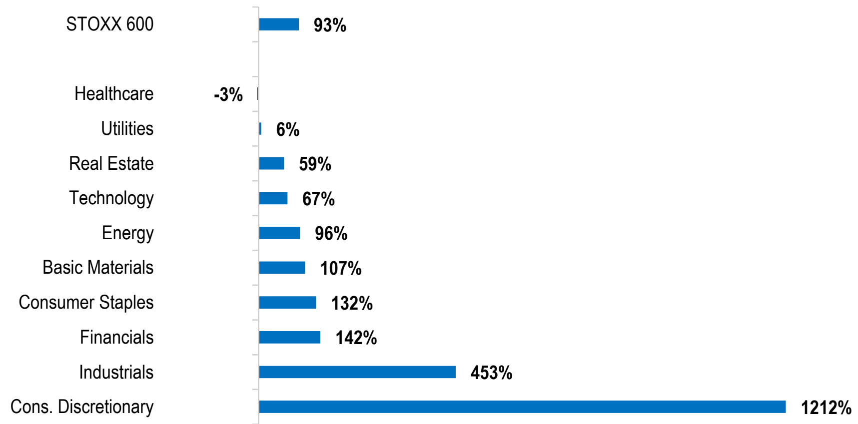
3/ **Stoxx 600 quarterly results (YoY, %)**



Source: Refinitiv IBES data, Amundi Research, Data as of 18 May 2021

4/ **Stoxx 600: Q1 2021 earnings (% chge YoY)**



Source: Refinitiv IBES data, Amundi Research, Data as of 18 May 2021

With 19 countries out of 21, emerging markets results bounced back on a wide front

Emerging markets also fared very well

Reporting season is also well along in emerging markets. As of 14 May, 74% of MSCI EM companies had already reported their first quarter numbers (source: Capital IQ). Riding a favourable base effect – the Q1 2020 EPS having dropped by 34% with the almost total shutdown of economies early in the pandemic – and a very robust rebound in revenues early in the year (+21% in Q1 2021), emerging market earnings staged a true take-off, soaring by +87% in dollars (USD) and even more in local currencies weighted by the size of the various markets.

Of the 21 countries in our sample, Q1 2021 results fell in only two, Indonesia (-6%) and Argentina (-40%), while most others achieved not only double-digit, but triple-digit growth! Some 63% of emerging market companies have beaten the consensus, but the extent of the good surprises is also impressive, at +19% above initial forecasts. Just one country, India (-1%) has undershot forecasts, but its results were still up sharply (+62%). By sector, gains were, unsurprisingly, especially strong in healthcare, basic materials and industry.

On a 12-month rolling basis, as of the end of March 2021, emerging markets results have moved back into positive territory (+4%), thanks mainly to the semiconductor-driven markets of Taiwan and Korea. Those regions still lagging behind on a 12-month rolling basis, such as Latin America and Russia within EMEA, are expected, in turn, to move back into positive territory in the coming quarters, while remaining volatile, due to base effects.

In reaction to these very good Q1 2021 numbers, we have raised our full-year EPS forecasts in emerging markets (in USD terms) from +24% at end-March to +34%.

In conclusion: beyond short-term doubts, a new phase in the market rally is looming – less strong but based more on fundamentals

Q1 2021 results rebounded to a surprising extent everywhere, with gains of about 50% in the US and 90% in Europe and in emerging markets, all of which benefited from a more favourable base effect. This bolsters consensus forecasts of a very

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A new phase looks probable, in which earnings growth would play key role

strong rebound in full-year EPS, with +35% for the MSCI World AC. The rebound is likely to continue beyond 2021, with further growth of 12% in 2022 and 10% 2023.

So, after last year's rerating, a new phase looks probable, in which earnings growth would play a key role in market performance. In the shorter term, however, as many flags of a recovery, such as inflation expectations, ISM data and earnings net-up, are nearing their peaks, equity markets could become more tentative in the wake of their strong gains since March 2020.

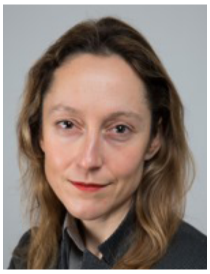
But this is unlikely to cast any doubt on their favourable outlook nine to 12 months out, as phases of outperformance by cyclicals generally last more than two years. Although their second derivative reading is receding, ISM and earnings forecasts are likely to remain very solid. Lastly, between rising interest rates and inflation, real rates are likely to remain quite moderate.

Amidst a likely generalised reopening of both developed and emerging economies, and in a context where bond yields should continue to move back to normal, it is probably worth sticking to a rather pro-cyclical bias, in value stocks in particular, rather than defensives and growth stocks. However, as the recovery matures, stock-picking is expected to become more selective. In sort, relative value will take over from value, and alpha will take over from beta.

Finalised on 19 May 2021

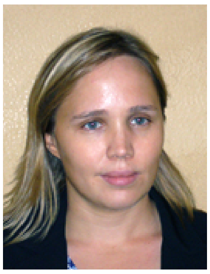
THEMATIC

A post-Covid structural change in developed markets: the strong political will to invest in the US



Valentine AINOUZ,
Deputy Head of Developed Markets Strategy Research

Mickael BELLAICHE,
Fixed Income and Credit Research Strategist



Delphine GEORGES,
Senior Fixed Income Research Strategist

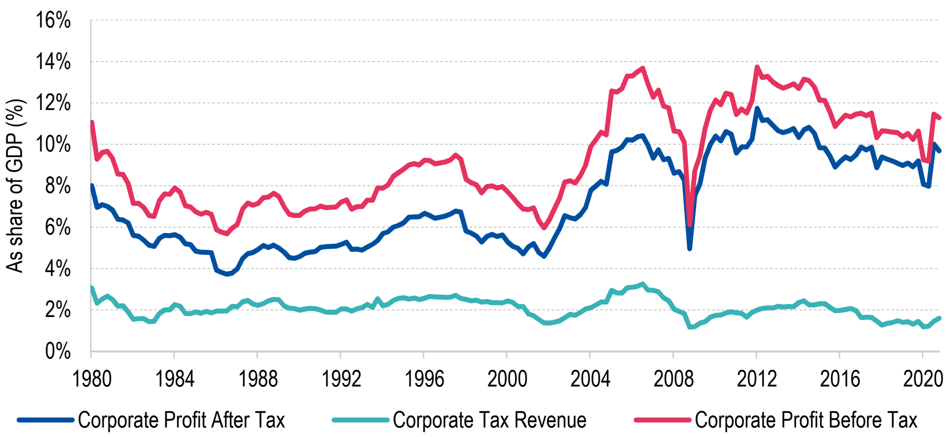
What matters to fixed income investors is the macro-financial environment that will prevail after the strong rebound in growth and inflation expected in H2. In a context where investors must question whether the change in consumer prices is transitory or a regime shift, it is important to focus on the sustainability of economic growth on the basis of capex trends. Indeed, US long-term economic growth could be boosted by a strong policy of investment (public and private). This would represent a strong contrast with Europe. What are the implications for fixed-income investors?

Biden's message is clear: investment is a top priority. The president argued that the United States' position as a preeminent global power was under threat from China if investments were not made. "Doing nothing is not an option". Biden said it would be unacceptable not to move forward: "America is no longer the leader in the world because we're not investing". China is "counting on American democracy to be too slow, too limited and too divided to keep pace" and "we can't afford to prove them right."

- **The US administration has proposed a two-part plan called Build Back Better of more than $4 trn over 10 years, after years of underinvestment in infrastructure and education.** These are the basic ingredients of long-term growth. It could have significant implications on long-term growth trends and productivity. The first part, the American Jobs Plan (AJP) amounts to more than $2tn in spending and tax incentives organised around four areas: 1) traditional infrastructure investments (roads, bridges, ports and digital infrastructure); 2) environmental infrastructure (water and energy); 3) manufacturing, supply chain and R&D initiatives (electrical vehicles and semiconductors); and 4) social welfare (investment in housing, childcare facilities, and upgrades of schools and community colleges). The second part is the American Families Plan of $1.8 trn over 10 years in new benefit spending and tax credits focused on child care and education. The new spending would raise total infrastructure investment to around 4.5% of GDP, the highest level since the 1970s. Infrastructure policies are the fiscal policies which have among the highest multipliers.
- **The tax reform proposed by the new administration aims also to improve economic efficiency via a better allocation of capital.** President Biden is in favour of raising corporate taxes to fund his infrastructure plan. However, we don't think it will penalise private investment. First, revenues from corporate taxation are beginning to look very low. The share of federal revenue raised by the corporate tax has fallen steadily for decades and is now under 10%. In contrast, the share of revenue raised by taxing labour has been growing and now exceeds 80%. Secondly, we think that aggregate demand matters more to the investment outlook than tax rate changes. Thirdly, there is no evidence that the 2017 tax law made substantial progress in long-term economic growth. The increase in corporate cash balances were mainly directed toward financing buybacks and dividend payouts for shareholders. Indeed, the recent jump in share buybacks has come almost entirely from companies with lowered tax rates.

"Doing nothing is not an option"
(Joe Biden)

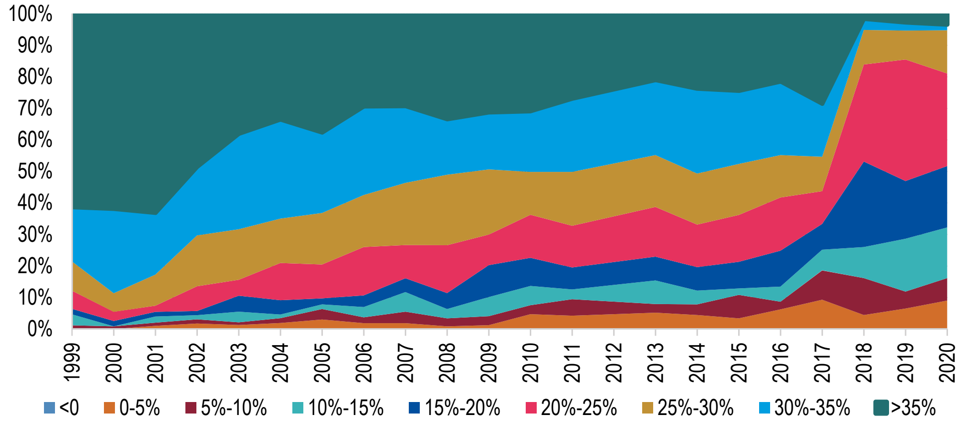
1/ **Corporate profit and taxes as a share of GDP**



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

THEMATIC

2/ **Distribution of effective tax rates among US IG**



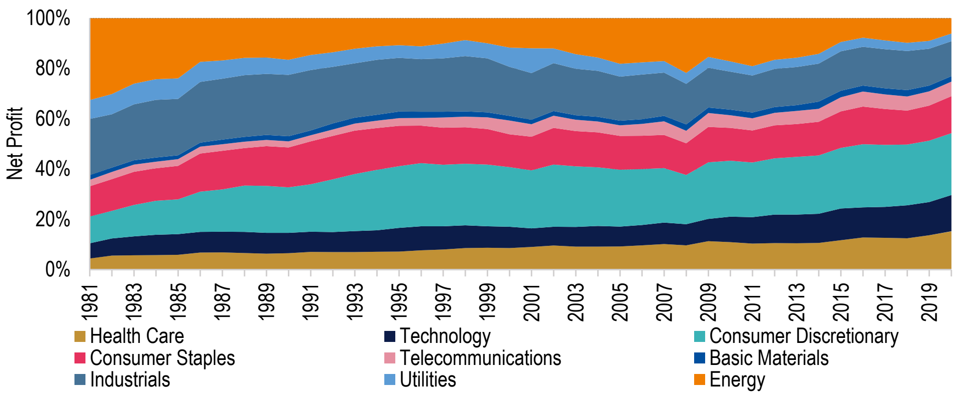
Source: Bloomberg , Amundi Research - Data as of 31 December 2021

The Fed is willing to let the economy run hot

In addition, we see a pick-up in private investment in the technology and consumer non-cyclical sectors. The change in the Fed's policy framework is providing strong support to the US economy. Indeed, we have observed a strong rebound in investment by American companies sustained by the very low interest rate environment.

- **Companies are benefiting from historically attractive financing conditions**. In 2008, the recession was triggered by an endogenous financial shock, which led to a prolonged period of tight financing conditions and private sector deleveraging. This time is different from 2008: the Fed's monetary policy has pushed the cost of debt to historically low levels, and activity on the corporate debt primary market remains very solid. On the one hand, the record low cost of funding has led to reduced interest payments on debt and improved corporate creditworthiness. The weakest companies (with the lowest ratings, affected by the Covid crisis) are taking advantage of low rates to refinance their debt and lower their average cost of debt. On the other hand, solid and well-capitalised companies are using the very low cost of debt to accelerate their development.
- **Cash on the balance sheets of S&P 500 companies is at an all-time high of $2.7 trillion.** Cash holdings along with improving cash flow could spark more capital spending, dividends and buybacks but also investment. The cash is concentrated in the technology, heath care and consumer sectors.
- **M&A activity remains on track in the United States and Asia despite the crisis.** M&A activity accelerated sharply during the second half of 2020; during this period volumes were the highest of all 2H periods since 2015. This rebound in M&A activity was driven by technology, consumer non-cyclical and communication sectors. These companies have outperformed in recent years and were the big winners of the crisis. Most of them are well-rated and well-capitalised. They have an offensive strategy and pursue external growth to gain in scale and diversity (by product, region, and customer). By contrast, M&A activity remains modest in Europe.
- **US capex was one of the surprising areas of resilience in the last quarter of 2020.** While capex is growing in most

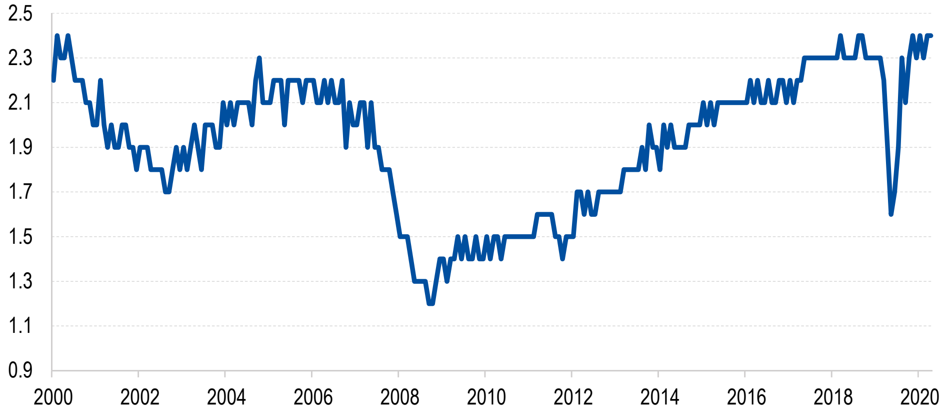
3/ **S&P500: U.S. net profit by sector (% total)**



Source: Datastream, Amundi Research - Universe: S&P500 ex. Financials and Real Estate
Data as of 31 December 2020

THEMATIC

4/ **Rate of job quitting (in %, SA)**



Source: Datastream, Amundi Research - Data as of 31 March 2021

areas of the economy, two areas stand out: technology and renewable energy.

Overall, the technology, health care and consumer discretionary sectors continue to show strong development. These sectors, which had already been driving the US economy over the past decade, are the big winners of the crisis. Interestingly, the situation on the labour market is completely different from that of 2008. Despite the high unemployment rate, we are already seeing tensions in the labour market. In the April NFIB Small Business Optimism Index report, a record 44% of surveyed businesses noted they had one or more jobs that could not be filled. People who have voluntarily quit their jobs have already returned to the pre-Covid level.

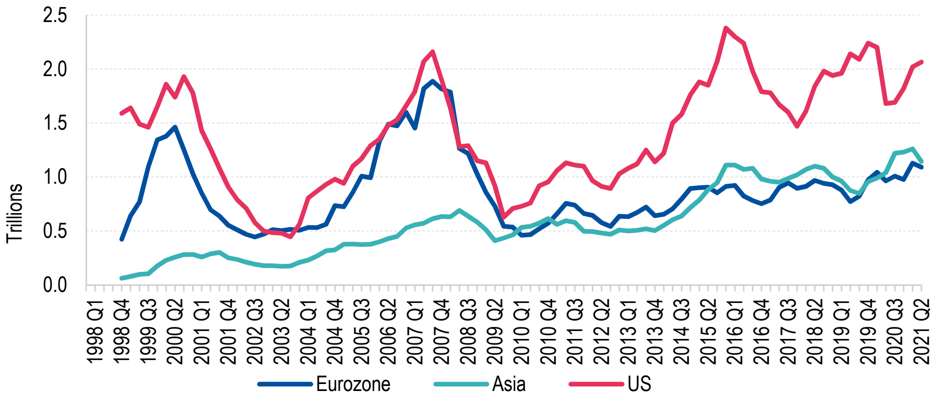
In the short term, strong growth and buoyant inflation will drive sovereign core bond yields higher. The coordinated response of monetary and fiscal policies to the Covid shock has been of unprecedented magnitude in peacetime, particularly in the United States. With the economic recovery accelerating, the case for shorter duration remain (in particular in the US).

Over the long run:

- **In the US, the current expansionary fiscal policy (BBB) and investment growth have the potential to raise the equilibrium real interest rate.** After decades of decline, the US real equilibrium interest rate is now estimated at around 0% to 0.5%. It could rise in the next few years as greater tolerance for budget deficits, unconventional monetary policy and structural measures to promote investment should lead to a new macroeconomic regime and a receding of the risk of secular stagnation.
- **The upside in euro core rates will be limited by the economic fragmentation between Eurozone countries.** The EU recovery fund (€750bn) and expansionary fiscal policy has allowed countries like Italy and Spain to have strong investment plans. However, public stimulus measures are not as ambitious as those planned in the US, and private investment has so far remained muted. The size of the EU recovery fund is not sufficient to compensate for years of underinvestment. Indeed, the last decade has been marked by a strong divergence in R&D expenditure among developed countries. The overall R&D-to-GDP ratio in Europe has been around 2%, i.e., significantly lower than in the United States, Japan, South Korea and

Over the long run, the US current expansionary fiscal policy has the potential to raise the equilibrium real interest rate

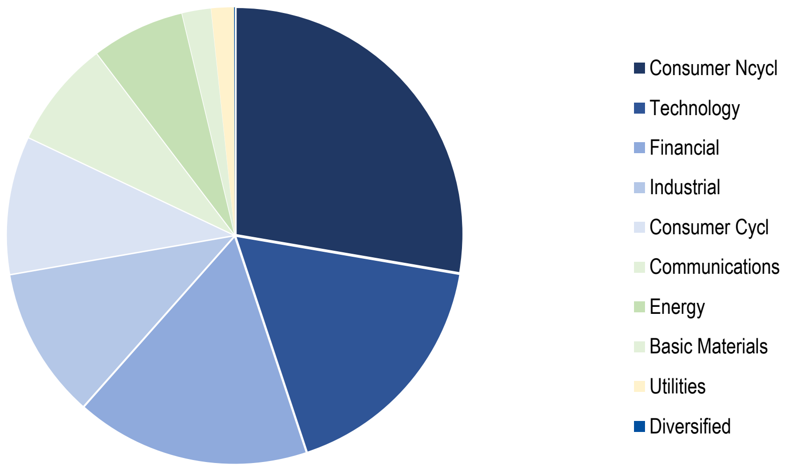
5/ **M&A volumes (trailing 4 quarters in USD)**



Source: Bloomberg, Amundi Research - Data as of 30 April 2021

THEMATIC

6/ **M&A activity in North America (last 12 months)**



Source: Bloomberg, Amundi Research - Data as of 30 April 2021

Singapore. R&D spending has been particularly low in peripheral countries. Barring a significant rise in growth expectations, the ECB stands alone in trying to avoid financial fragmentation. The ECB's ability to stabilise the markets is thus essential. Fiscal policy can only be effective if sovereign yields remain low and stable even in the face of growing deficits. Otherwise, divergences on the ECB board are likely to increase as the economic recovery starts, as the debate on the assessment of "favourable financing conditions" is still open within the ECB.

Finalised on 20 May 2021

THEMATIC

NGEU soon to be rolled out: the EU has (almost) done its part; now comes the member-states' turn

Tristan PERRIER,
Global Views

In leading the way to NGEU, the Covid crisis may have marked a crucial milestone in European construction. The amounts involved are high enough to play a decisive role, both in accelerating the cyclical recovery (especially in "peripheral" countries) and in providing a supply-side improvement. Member-states, however, will face a major challenge in absorbing them rapidly and productively.

The launch of the European recovery fund, called Next Generation EU (NGEU), is potentially a big step forward for at least three reasons:

1. From a cyclical point of view, NGEU is raising heavy amounts in order to support demand and accelerate the post-Covid recovery, in particular in "peripheral" countries, which have been hit harder by the crisis and are threatened with falling even further behind "core" countries.
2. From a structural point of view, it can be a powerful way to combine public investment and reforms to improve supply and, hence, potential growth.
3. It is also a significant step forward in terms of European fiscal solidarity, with the EU issuing debt in its own name (thereby also creating a European "risk-free asset" in large amounts) and distributing grants to member-states in amounts that are not proportional to their GDP.

The July 2020 agreement to create the fund helped calm the tensions that opposed Italy to other EU countries early in the Covid crisis. This political lull helped narrow sovereign spreads of peripheral member-states, both by itself and by facilitating the ECB's task. Hence, and before even being rolled out, NGEU has already indirectly helped those member-states fund their own fiscal response to the crisis.

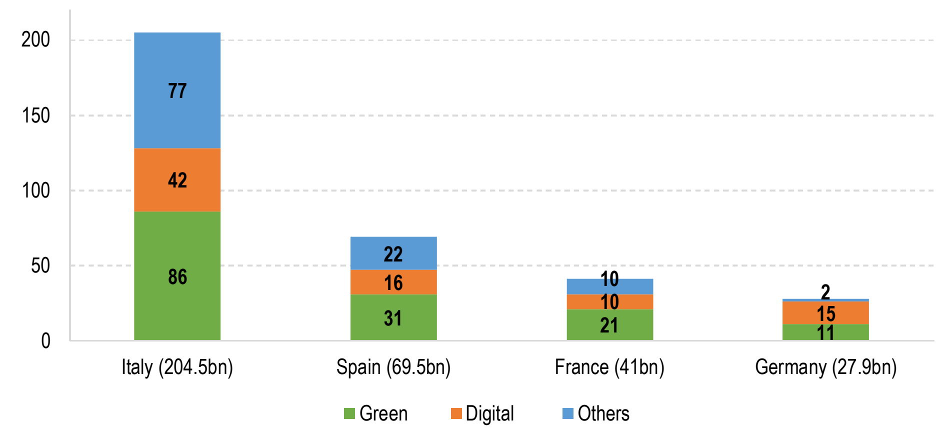
Before even being rolled out, NGEU has already helped calm political tensions and brought indirect fiscal support

Keep in mind, however, that NGEU is more comparable to the Biden administration's infrastructure plans (announced but not yet approved) than to the fiscal support measures already deployed in the US. The EU equivalent of the latter have been, basically, handled by member-states, which have tapped their budgets massively since Q1 2020 to maintain household income and guarantee companies' liquidity (however, in addition to ECB support, the EU did act by loosening regulatory constraints and rolling out some smaller programmes).

NGEU is now being rolled out. Some member-states have still not submitted their investment and reform plans, but the four main ones, as well as other peripheral countries, such as Portugal and Greece, did so by the (albeit non-binding) deadline of 30 April. Meanwhile, all countries have now approved the "own resources" principle (which allows debt-raising in the EU's name). Hence, a first release of funds could in theory happen as early as July (counting the c. 8 week delay from April 30 for Commission and Council approval of countries' plans) or, at the latest, in September.

On paper, the projects being proposed by the main member-states are in accordance with Commission expectations. The reforms that member-states have pledged to make comply with the Commission's recommendations, particularly those formulated in the framework of the "European Semester" process (especially as anti-Covid recommendations had in part replaced the usual requests for structural

1/ **NGEU: Ressource allocation, €bn 4 main euro countries**



Source: Bruegel Estimates, Amundi Research. Data as at May 2021

THEMATIC

The main challenge will be fund absorption against a backdrop of heavy country-level decision and implementation processes

reforms in 2020). Investment programmes also seem to comply on the whole with European recommendations (particularly the mandatory 37% and 20% earmarked for green and digital transformation), keeping in mind that country-by-country comparisons of amounts are hindered by the presence of national stimulus plans alongside NGEU (such plans are larger than NGEU in Germany and France, and smaller in Italy, while Spain does not currently announce a national top-up of NGEU). While the Commission will no doubt ask for some details (particularly concerning project follow-up mechanisms), its initial green-light is likely.

However, the main medium-term challenge is in member-states' ability to absorb the funds. Past experience of European investment plans (the Junker plan, for example) has shown that this is a real challenge. The Bruegel Institute, a think tank whose findings were taken up in a recent ECB[1] release, pointed out that several EU countries (notably Italy and Spain, the two largest NGEU beneficiaries) have had difficulty in recent years using the EU amounts made available to them, amounts that were far below those provided under NGEU. Generally speaking, public investment, which theoretically carries significant multiplier effects on GDP, tends to run into high bureaucratic barriers or even opposition from various vested interest groups.

The balance between NGEU's two main economic mandates (temporary demand-side support and structural supply-side improvement) could also evolve over time. As many services sectors are just now reopening in Europe after anti-Covid restrictions, it is still not clear how long it will take for the economy to return to normal (or at least to close the "output gap") and, hence, how much prolonged, on-demand fiscal support will be needed. Depending on the state of the economy in a few months, consideration may be given to shifting some expenditure in this direction or, on the contrary, to focusing on the supply side and long-term competitiveness, as the programmes that best meet both of these types of objectives are not necessarily the same. The usefulness of an additional EU fiscal plan (something that a number of economists have called for, and that has been mentioned by the French president), and its nature will also have to be reconsidered against this yardstick.

On the whole, NGEU, a potentially powerful mechanism that has been agreed and launched by the EU quite rapidly, is an adequate response to any shortage of fiscal resources that could hinder public investment capacities. The ball is now in the court of the member-countries to prove that investment is not being held up by their internal heavy decision-making and implementation processes. The success or failure of these investment programmes and of the reforms that must accompany them, will constitute an important precedent that will no doubt be cited by proponents and opponents of additional steps forward in EU fiscal solidarity.

Finalised on 24 May 2021

[1] *Will EU countries be able to absorb and spend well the bloc's recovery funding?, Zsolt Darvas, Bruegel, Sep 24, 2020. Mentioned in the ECB's Financial Stability Review, May 2021.*

Box: an NGEU primer

- NGEU's amount is €806.9bn in current prices (€750bn in 2018 prices), equivalent to c. 5% of EU GDP, to be disbursed between 2021 and 2026. 70% of the amounts are expected to be committed (not necessarily disbursed) between 2021 and 2022, and the remaining 30% in 2023.
- The budget breaks down between €723.8bn for the Recovery and Resilience Facility for loans (€385.8bn) and subsidies (€338bn) to member-states. Another €83.1bn is being provided to support other European programmes.
- The two main beneficiaries are Italy (c.€200bn, or 11% of GDP) and Spain (c. €150bn, or 12% of GDP). For the moment, while Italy has officially requested all of these sums, Spain has asked only for the grants, while postponing its decision on loans.
- Based on approval times of the European Commission and Council, the first amounts could be disbursed no earlier than July (to countries that have submitted their reform and investment plans).
- Beneficiary countries should obtain prefinancing of 13% of their entire programmes as early as 2021.
- To fund the programme, the EU will take on debt in its own name, with repayments scheduled from 2028 to 2058.

THEMATIC

RMB internationalisation: the new commanding heights

In the early stage of RMB internationalisation, RMB transactions occurred mostly in trade settlement between China and neighbouring economies. As China liberalises its capital account and rolls out the Belt & Road scheme, RMB's investment & financing functions have soared. To thrive in the next stage of Internationalisation, we believe there are three areas (the new commanding heights) in which Beijing has genuine interests to drive ahead: 1) Pursue a higher level of opening of financial markets, 2) Promote the anchor role of the RMB for Belt & Road and Asian economies, 3)Build next-generation infrastructure.

Alessia BERARDI,
Head of Emerging Macro and Strategy Research

Claire HUANG,
EM Macro Strategist

The underlying driver for using RMB shifted since late 2016

How far has the RMB gone?

A look at SWIFT transaction data often leaves a false impression that RMB internationalisation progress has stalled, since RMB's share in the global payments market has stayed below 3% for six years (Chart 1) and its popularity rank appears to be stuck in fifth place after USD, EUR, GBP and JPY. This, however, understates RMB settlement that happens outside of the SWIFT platform, as China launched its own payment system CIPS in October 2015. In five and half years, transactions through CIPS have risen to RMB 45.2tn ($6.5tn) in 2020 from none, driving cross-border RMB settlement in trade and investments to triple in 2020 from 2016-17, a much faster rate than SWIFT transactions would otherwise suggest.

Nevertheless, **the underlying driver for using RMB shifted when investment and financing demand started to outpace trade flows in late 2016.** The integration of China's onshore market with the rest of the world has witnessed an increase of global asset allocation into RMB assets. The share of RMB in global FX reserves more than doubled, from 0.8% in Q4 2016 to 2.1% in Q4 2020 (Chart 2). Non-residential investors held a total of RMB3.4tn in Chinese A shares as of the end of March 2021, 5x more than end-2016; positions in China's domestic bond market increased to RMB 3.7tn, 4x more than at end-2016 (Chart 3).

The next stage of internationalisation

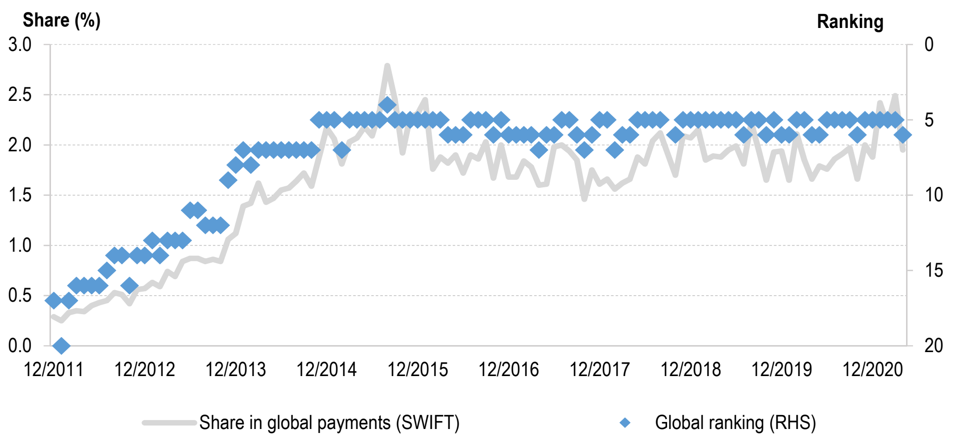
Following the initial boom, there are greater barriers in raising RMB's status even further. Besides, the ball is not always in China's court. Shifting geopolitical tides, for instance, will complicate the picture. In the 14th Five Year Plan, China vows to steadily and prudently promote RMB internalisation within a market-driven approach, and to build mutually beneficial partnerships based on the free use of RMB. This is an approach that lays more stress on the free choice of using RMB.

To thrive in the next stage of internationalisation, RMB's prospects may well depend on China's progress in following areas.

1. A higher level of financial sector opening-up

A more open, transparent and sophisticated market that delivers returns will help retain foreign investments in the long term, a main driver for RMB flows. From the policy point of view, this involves providing a wider range of products, equal access to all, and an increase in types of participants. In 2020, financial liberalisation promises were delivered without delay (e.g., removal of foreign ownership limits), showing it remains a policy consensus to pursue a higher level of opening-up of the financial sector.

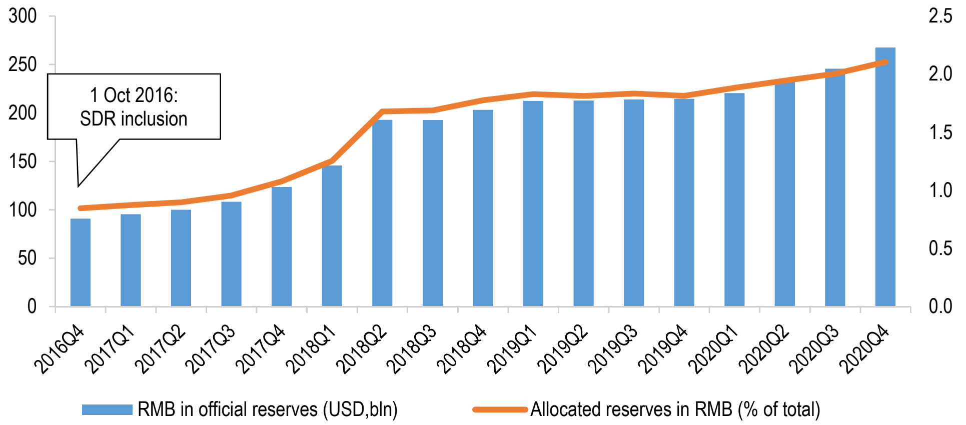
1/ **RMB's share and ranking in SWIFT payments**



Source: SWIFT, Amundi Research. Data as of 20/05/2021

It remains a policy consensus to pursue a higher level of opening-up of the financial sector

2/ Global FX reserves allocated to RMB



Source: IMF, Amundi Research. Data as of 31/03/2021

That said, China has progressed more quickly on relaxing barriers for foreign investors, but not the other way around. Hence, overseas investments from domestic institutions have been effectively capped by existing quotas, mainly QDII ones. Given that this policy preference is here to stay, portfolio inflows are likely to continue outpacing outflows, adding upward pressures on the RMB in the medium term until inflows peak.

2. The anchor role of the RMB

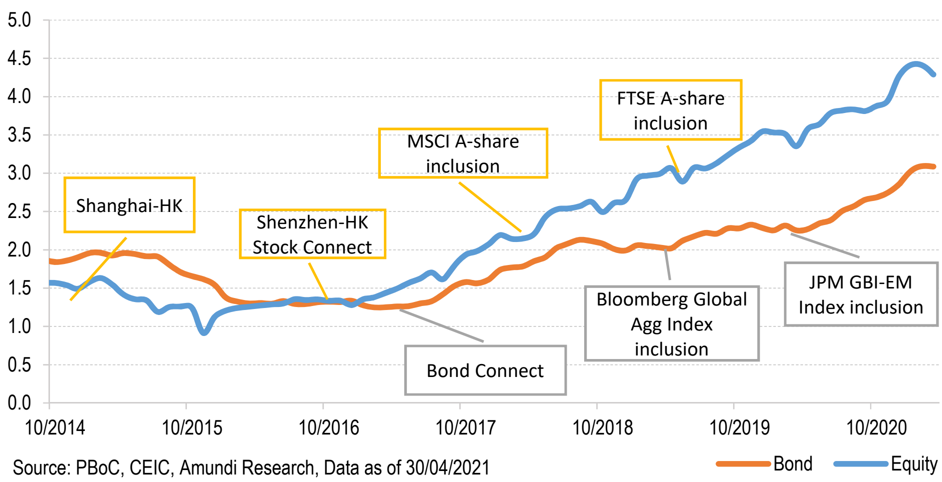
In Q1 2021, cross-border RMB receipts and payments accounted for nearly 50% of BoP flows, up from less than 20% in 2016. The PBoC revealed that transactions with Asian economies and the Belt & Road economies grew quickly. The trend was facilitated by the string of RMB offshore clearing banks in the related countries, and set-ups of bilateral currency swap agreements between the PBoC and peer central banks. Multilateral cooperation among the Asian central banks have gained pace, the amendment to Chiang Mai agreement (CMIM) now allows the use of members local currencies in addition to USD for financing within the total capacity of $240billion[1].

While RMB is branded as an alternative choice to the dollar for Belt & Road countries and neighbouring Asia economies, **exchange rate stability is desirable with non-dollar currencies.** This resembles the early integration effort of European economies in creating the "snake in the tunnel" mechanism, under which member states' currencies could fluctuate within narrow limits against each other and the dollar[2]. That said, instead

[1] *The amended Chiang Mai Initiative Multilateralisation (CMIM) Agreement, which is a regional financing arrangement by ASEAN member states, China, Japan and Korea (ASEAN+3) and the HKMA, came into effect on 31 March 2021. The amendment allows the use of members' local currencies, in addition to the USD, for financing on a voluntary basis within the standing financing capacity of USD 240 billion.*

[2] *On 24 April 1972, EEC central-bank governors concluded the 'Basel Agreement', creating a mechanism called the 'Snake in the tunnel'. Under this mechanism, Member States' currencies could fluctuate (like a snake) within narrow limits against the dollar (the tunnel) and central banks could buy and sell European currencies, provided that they remained within the fluctuation margin of 2.25%. Source: EPRS - [A history of European monetary integration](#).*

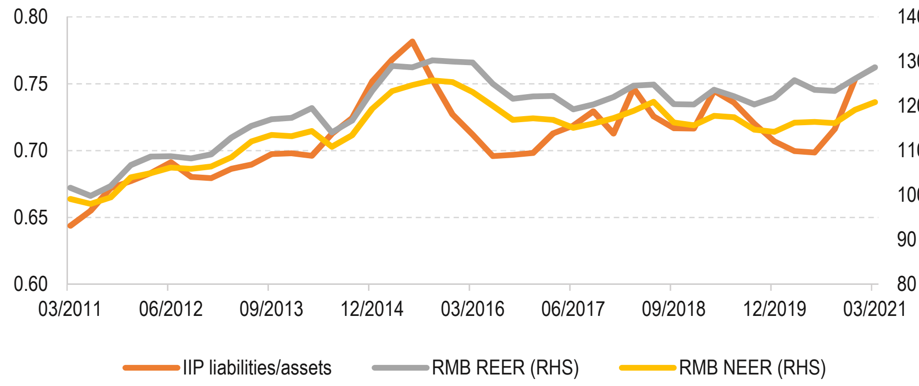
3/ Foreign investments in Chinese markets



Source: PBoC, CEIC, Amundi Research, Data as of 30/04/2021

THEMATIC

4/ China's international investment position and currency



Source: SAFE, BIS, CEIC, Amundi Research. Data as of 19/05/2021
IIP=International Investment Position. Liabilities = Non-residential investments in China.
Assets = Residential investments to other countries. REER= Real Effective Exchange Rate. NEER= Nominal Effective Exchange Rate

The digital CNY can play a role in internationalisation through multi-CBDC arrangements

of limiting its movement against the USD, the PBoC has chosen to tolerate higher volatility in the USD/CNY pair, in exchange for lower volatility of the RMB against other currencies (Chart 5). Essentially, the central bank releases the USD/CNY fixing rate on a daily basis, which in a large part reflects the overnight movement of a basket of currencies against the dollar. By matching the reference basket's movement against the dollar in daily pricing, RMB is able to anchor itself with the reference basket, without an actual Asian currency bloc.

3.Next generation of infrastructure

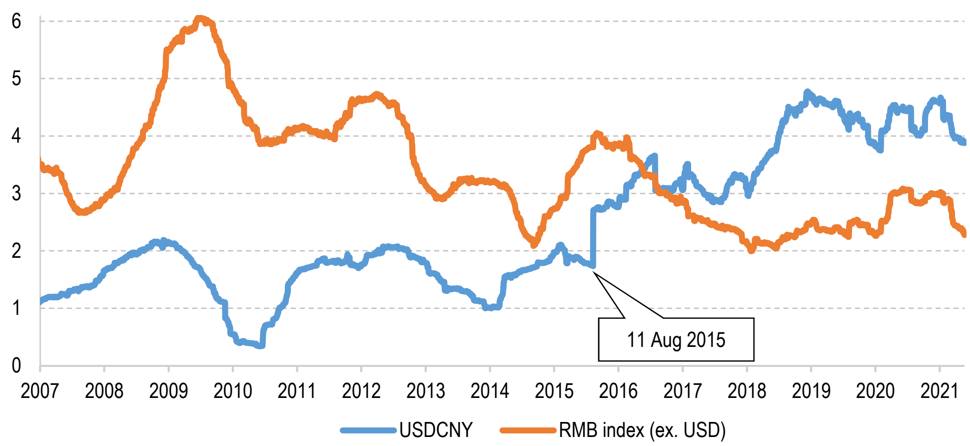
At the time of this writing, China's digital CNY pilot has expanded to cover 10 cities, plus the Beijing 2022 Winter Olympics, to replace part of the currency in circulation (M0). While the digital CNY is still in its infancy, a multilateral project sheds light on what role the digital CNY could play in RMB internationalisation.

In February, PBoC and the Central Bank of the UAE announced they were joining the second phase of the Inthanon-LionRock project, which was initiated by the HKMA and the BoT. The project, targeted to support real-time cross-border transactions 24/7, shows **the possibility of a future multi-CBDC arrangement among the central banks.** Through compatible standards agreed by CBDC-issuing countries, central banks are able to reduce the costs and improve the transparency of cross-border flows. Former PBoC governor Zhou suggests retail use should be the focus of digital currency in cross-border payments.

The roll-out of PBoC's digital CNY and its leading role in designing the multi-CBDC arrangement show China is paving the high way for future RMB payments across the borders, in particular Belt & Road and Asian economies.

Finalised on 21 May 2021

5/ Foreign exchange rate volatility (annualised, %)



Source: Bloomberg, Amundi Research. Data as of 21/05/2021

CENTRAL & ALTERNATIVE SCENARIOS (12 TO 18 MONTHS HORIZON)

Monthly update

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

DOWNSIDE SCENARIO 10%

Multifaceted pressures*

Analysis

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

Market implications

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

CENTRAL SCENARIO 70%

Multi-speed recovery

Analysis

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

Market implications

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

UPSIDE SCENARIO 20%

Sustainable & inclusive recovery

Analysis

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

Market implications

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

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

TOP RISKS

Monthly update

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

ECONOMIC RISK 15%

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

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

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

FINANCIAL RISK 20%

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

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

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

(GEO)POLITICAL RISK 15%

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

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

➖ **Oil, risky assets, EMBI**

CROSS ASSET DISPATCH: Detecting markets turning points

How to the read turning point assessment

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

ECONOMIC BACKDROP

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

FUNDAMENTALS & VALUATION

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

NEUTRAL + ASSET ALLOCATION

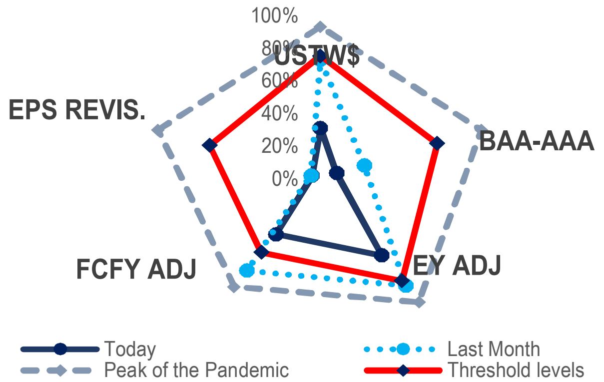
TECHNICALS

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

SENTIMENT

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

Cross Asset Sentinels Thresholds (CAST) still supportive



Source: Amundi Research, Data as of 13 May 2021

CAST flags extremely low risk perception.

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

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

GLOBAL RESEARCH CLIPS

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

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

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

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

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

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

4 Japanese growth downgraded on Q1 GDP miss and slow vaccination

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

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