Research

#09
September
2021

CROSS ASSET
Investment Strategy

CIO VIEWS

Markets in 3D: Delta, Deceleration and Divergences

THIS MONTH'S TOPIC

Special Europe: invest in the recovery

Confidence must be earned

Amundi
ASSET MANAGEMENT

#09 - September 2021

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The spread of the Delta variant and the resultant mild stabilisation of economic momentum allow us to remain neutral on equities. However, investor should be prudent to maintain hedges, with a view that Europe appears attractive from a valuations perspective. On duration, we remain defensive but flexible, given our view of upward yield movements although this will not be linear. On the other hand, EM present divergences and there is a need to exercise caution in light of headwinds from potential increase in US core yields. Overall, a balanced and vigilant stance is the need of the hour.

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In this context, we like periphery bonds and in particular Italian bonds in absolute and relative term. Within the European credit markets, we prefer high beta segments such as subordinated debt and BBBs within IG and high and mid-rated corporates within HY. We reiterate our positive stance on European equities, which brings a cyclical and value tilt to the portfolio. We also highlight the positive impact of NGEU for Central and Eastern European countries.

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As a complement to the Special Europe report, we try to answer some of the key questions often asked.

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Persistent supportive funding conditions and the improved macro picture are consistent with a current and expected benign picture for US and European default cycles, which are likely to remain on a downward trend in the coming months. Emerging markets' high yield corporate default rate remains quite low and we expect a further decrease in the next month. Higher risk in China, in particular in the property sector. Beijing will continue with financial de-risking and reducing housing sector leverage but systemic financial risk will be prevented.

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The shock to the Eurozone job market in 2020 was considerable. Hardest hit were southern countries, young people and women. We discuss below these various factors of market fragmentation in the largest Eurozone countries. In addition to aggregate employment figures, major central banks are looking more and more closely at the structure of employment (by gender, skills and country), as excessive job market fragmentation could undermine medium-term price stability. This includes the ECB. The lack of convergence could be one justification for keeping monetary conditions accommodative for a long time to come.

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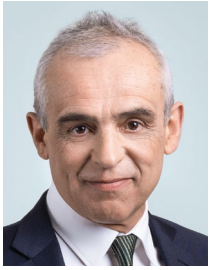
CIO VIEWS

Markets in 3D: Delta, Deceleration and Divergences



Pascal BLANQUÉ,
Group Chief Investment Officer

Vincent MORTIER,
Deputy Group Chief Investment Officer

Equities have remained buoyant over the past weeks despite some challenges (China regulation, Afghanistan crisis), primarily due to the exceptional earnings seasons in the US and Europe. Looking ahead, **we identify three main themes: the spread of the Delta Covid variant, the deceleration of economic growth from its peak, and divergences in policies**. On the first D, Delta, the resurgence of Covid-19 cases in the US and Europe has been a key topic, with the return of the so-called lockdown trades penalising travel and leisure stocks and favouring more defensive companies. We believe that the market has probably gone a bit too far with regard to pricing in the potential for new lockdowns. This may have opened up opportunities in the most affected sectors.

The fear of global spread of the Delta variant overlaps with the second D, a deceleration in economic growth already in process, both in the US and China. The EZ, in contrast, is still climbing the hill, with the peak likely to be reached in the next one or two quarters, lifted by the periphery, in an inflationary environment that remains more benign than for the US. All these factors translate into diverging monetary policies among the US, China and the Eurozone. In the US, the acceleration in the job market recovery, coupled with higher inflation, is paving the way for tapering talks. China looks to be moving towards an easing bias, and the ECB remains broadly accommodative. Also, the fiscal side could play relatively in favour of the EZ in the coming months, but in US, most of the fiscal accommodation is behind us and the infrastructure plan will take years to become effective.

Now, the 3Ds are building a fertile ground for a return of market volatility, acting as a trigger for a pause in the equity rally and for relative value. This means that investors should stick to some key convictions:

- **While staying overall neutral on equity, it is wise to have protection in place**. Given negative real rates for bonds, equity remains the key alternative – even more so if bond yields are set to rise less than inflation, manipulated by policy actions, and dividends remain well-sustained. In the short term, investors should be prudent and build some hedging in case of a fast deterioration of economic conditions due to the virus cycle. Also, we can expect that the extraordinary earnings growth this year will not be repeated. Companies have been able to broadly pass on higher costs to consumers, but if – as we believe – inflation is going to be less temporary than expected, higher wages will follow. This has not yet materialised. While at regional level we keep a neutral stance, we recognise that on a valuation basis, Europe is more appealing, as it has not yet reached the peak in terms of growth and policy action is still supportive.
- **The equity value call is intact, despite the summer weakness.** This is giving investors a second chance, if they had not embraced the trade in November, to enter a multi-year trade. The first leg was primarily a cyclical value call; the second wave could be more supportive for interest rate-related names (banks/financials) and prove beneficial to companies with attractive valuations (energy in the US).
- **A short duration stance remains the name of the game in Fixed Income.** The search for income continues to favour peripheral Europe, IG and HY global credit, including Chinese bonds. The high level of leverage is an area to pay attention to for credit, which should be monitored based on a perspective of higher rates. This makes the case for selection at the corporate level paramount.
- **We stay neutral overall in EM equities, but see divergences.** Short term, we are more cautious on China amid the regulatory wave while we are constructive on India and Brazil, where the worst of the Covid crisis is likely now behind us. On China, we retain our long-term positive call and believe that recent weakness has opened up interesting opportunities. Investors could take advantage of the sell-off to increase their allocation in Chinese equity in global portfolios and manage the current phase focusing more on the sectors that are insulated by changes in regulation, such as biotech and clean energy-related stocks. On EM bonds, a key engine of income, the view is still cautious. The perspective of Fed tapering makes us prudent on duration, favouring HY, as well as on some idiosyncratic stories that need to be monitored (Cambodia, Thailand, Peru, Chile, Brazil) for political risk.

In conclusion, we reiterate the need to stay vigilant, on the one hand, but not become overly pessimistic, on the other. Markets are balancing less brilliant news from the economy with policy action. All this means that scrutiny of investment cases should be high, as there is little room for mistakes at current market valuations.

Overall risk sentiment

Risk off **Risk on**

Slightly more cautious on risk assets as valuations are tight amid cyclical growth/ demand deceleration from peak, high inflation and Covid delta variant.

Changes vs. previous month

- Neutral on EM and China equities in the short term
- More cautious in US credit selection

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

MACRO

China: short- and medium term views

Monica DEFEND,
Global Head of Research

Alessia BERARDI,
Head of Emerging Macro and Strategy Research

Recent weakening of data will result in a more dovish stance from policymakers who in the long-term aim for a modern socialist society, where economic gains and wealth are more equally distributed

Growth downgrade: July's monthly data point to a broad economic slowdown in China. Production, consumption and investment all disappointed. The broad policy tapering, together with the sector-level tightening, was the major culprit behind the slowdown. Housing indicators dropped notably in July, with property investment growth declining to low single digit for the first time since April 2020 (1.2% yoy in July). Meanwhile, Delta variant risks will likely become more visible in August consumption data, given the expansion of social distancing rules since late July. As a result, we downgraded our Q3/Q4 growth forecasts to 6.4%/4.7% (yoy) from 7%/5.1%, expecting much slower sequential growth in Q3. Consequently, the **2021 annual growth forecast was lowered to a range of 8.4-9.0% from 8.6-9.2%; 2022 growth was kept unchanged at 5.1-5.7%.**

Policy to turn more dovish: In light of the weakening growth momentum and the inflation risks, China's policy stance is expected to turn more towards the dovish side. That said, we expect **policy loosening to come from the credit and fiscal sides** while the PBoC should keep an accommodative liquidity stance without rate cuts (with mounting expectations of a RRR cut in 4Q21). Right now, rate cuts won't help much if the grip on credit pipelines remains tight and if a full scope policy easing is not on the cards. Top-down credit rationing and sector tightening were the main issues. Money was directed into the manufacturing sector, but this sector's capex alone is not enough to offset the slowdown in the infra and housing sectors. A likely combination of policy tools turning more dovish should account for credit loosening and the credit impulse bottoming: on-budget fiscal spending picking up through a rise in monthly issuance of local government bonds (likely in Aug/Sep/Dec) while off-budget debt (LGFV/local SOE) tightening should continue.

On monetary policy, the PBoC should maintain an accommodative liquidity stance, without rate cuts, the MLF rollover staying generous, only slightly below maturing amount and one additional RRR cut likely announced in late Oct/early Nov, given the medium- to long-term lending facilities maturing schedule. While the regulatory changes are unlikely to stop, they are expected to be paced and spread out over a longer horizon. Property market tightening is likely to continue.

Medium-term view: To build a great modern socialist country by 2049, China has been identifying several pillars and GDP growth performance is still an important objective. China wants to double GDP by 2035 vs 2021: that implies an annual GDP growth rate that becomes progressively lower in the next two decades, from 5.5% yoy to 4% yoy. Moving to higher-quality growth means investing in human capital, with the population peaking in 2026 (Amundi estimates); transitioning to green with carbon emissions peaking in 2030; and channelling credit more efficiently. The opening up of China has to be secured through an independent supply chain and an incrementally globally relevant financial market (Belt & Road Initiative, RMB internationalisation). **The second pillar concerns the spreading of wealth,** raising the share of middle income through tax redistribution, a fall in urban-rural and regional imbalances, and enhanced regulations (anti-monopoly, anti-corruption). **Third, to develop a more efficient credit mechanism and an open financial market, defusing financial risks is key. T**he first steps are already visible in the increasing number of defaults: large SOE are now in the headlines and are testing the financial de-risking agenda. How Beijing deals with stressed public companies where financial risk could escalate to systemic levels will provide clarity on government's commitment to the agenda and risk tolerance.

China: three pillars in achieving common prosperity	
High-quality growth	Doubling of GDP in 2035 vs 2021. Progressively lower GDP: 5.5% (2022-25), 4.0% (2031-35)
	Domestic circulation: reforms & productivity boost: (L Challenge) demographic peak in 2026; revive fertility, invest in human capital. (K challenge) Green Transition: carbon neutrality in 2060; Credit efficiency
	External circulation: balance opening up with security (Independent and secure supply chains; Financial market liberalisation to go along with Belt & Road, RMB internationalisation)
Spread the wealth	High share of middle income: redistribution via tax (property, inheritance, capital gains), social security, donation
	Transform corporate sector: Fill in regulatory blanks, CSR, anti-monopoly, anti-unfair competition, anti-corruption
	Address rural-urban imbalance, regional imbalance: Increase rural household incomes; land use rights
Defuse financial risks	

Source: CPC Constitution, Xinhua, Amundi Research. August 2021.
RRR = Reserve requirement ratio, BRI = Belt & Road Initiative, RMB = Renminbi, LGFV = Local Government Financing Vehicle, SOE = State Owned Enterprises

MULTI-ASSET

More prudent in complacent markets

Matteo GERMANO,
Head of Multi-Asset

We maintain good sensitivity of our portfolios to risk assets but acknowledge a stabilisation in economic momentum. Thus, investors should keep hedges in place and stay active

As we monitor the next sequence of economic growth and inflation, it looks like global activity is stable amid policy support from governments. Consequently, we maintain a neutral stance on risk assets but continue to monitor the deceleration in economic activity, tensions in Afghanistan, and elections in Europe. In addition, some corners of the market are showing headwinds to the reflationary trade while others remain resilient on the belief that central banks will step in if needed. This is not a time to change core convictions but to increase vigilance, as both equity and bond valuations are quite tight. **Therefore, with an overall neutral view on risk assets, we believe it is important to maintain hedges on equity exposure**.

High conviction ideas

With an overall neutral stance on equities and a pro-cyclical approach, we are monitoring key developments, particularly in the US, Europe and China. As inflation remains a key topic, consumer sentiment and data point to some weakness. This doesn't mean a change in stance is required, but it underscores the importance of a vigilant, selective approach because the eventual level of economic growth may be less benign for risk assets and that is currently not factored in by markets. On EM, the view is neutral. We downgraded China equities from a marginally positive stance earlier as we evaluate the consequences of regulatory action in pursuit of the government's social objectives. Another issue is the US-China geopolitical relationship and subsequent liquidity issues when investing in China. However, in the long term, these measures could be beneficial and provide good entry points.

In fixed income, we think current core yield levels are not consistent with our higher inflation outlook, leading us to **maintain a cautious view on duration in US (UST 10Y) and core Europe,** in line with our expectation for rising rates and economic recovery. But investors should remain active and adjust stances if sentiment changes.

The relative value in European peripheral debt favouring the 30Y BTP vs the Bund is attractive due to a rebound in expectations regarding Italy and continuous support from the ECB.

Search for income and global diversification opportunity presented by the Chinese government local debt still hold true as the country continues to offer attractive real yield. China's debt markets should benefit from its rising economic/geopolitical clout and inclusion in global indices and the resultant positive effect on inflows mainly from passive investors, notwithstanding the recent regulatory actions. On EMBI spread, we keep a neutral view.

In a world with high negative-yielding debt, credit offers some respite. Credit metrics are improving in Euro IG even as the asset class offers carry amid ECB support. But selectivity is important as valuations are tight. Euro HY also offers scope due to prospects of a better default outlook in light of economic recovery.

When risks are asymmetric and uncertainty is high, relative value is the only value left to explore. For us, FX is a playground to implement such long-term as well tactical strategies. Regarding the former, we believe in an ongoing recovery and are positive on a carry basket via NOK, GBP and USD vs the EUR and JPY. However, we see some headwinds that may affect the CAD, leading us to downgrade it vs the CHF. In addition, the current dynamics we are seeing in the FI markets (especially in the US) do not favour a negative view on the CHF. In EM FX, however, we continue to like the BRL/EUR owing to improving vaccination levels, economic growth, and potentially higher rates.

Risks and hedging

We see risks related to the Delta variant and a possibility of additional waves after the summer, coupled with the situation in Afghanistan and how it could affect portfolios. As a result, investors should keep hedges in the form of derivatives to protect DM equity allocation, as markets are priced for perfection.

Amundi Cross Asset Convictions

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

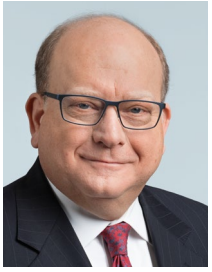
Source: Amundi. The table represents a cross-asset assessment on a three- to six-month horizon based on views expressed at the most recent global investment committee. The outlook, changes in outlook and opinions on the asset class assessment reflect the expected direction (+/-) and the strength of the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

Divergence between nominal yields and inflation

Amaury D'ORSAY,
Head of Fixed Income

Yerlan SYZDYKOV,
Global Head of Emerging Markets



Kenneth J. TAUBES,
CIO of US Investment Management

We have seen a shift in market narrative from 'dominant inflation' to 'growth on the downside.' This doesn't mean inflation has disappeared, but indicates market fears in the next phase

Spread of virus variants, overdone growth worries, and unconventional monetary policy mainly explain the fall in core yields and the latter's divergence with actual inflation numbers. Despite some slowdown in economic momentum, growth is still strong and not falling off the cliff. From another perspective, monetary policy has aggravated inequalities by affecting workers' real disposable incomes and increasing the wealth of the rich. Wage growth could further add to inflation pressures. As we get more clarity on the Fed's tapering plans, yields should move up, in a non-linear way. In addition, once the markets are convinced that inflation is more than just 'transitory', the divergence between yields and inflation should decrease. We keep a cautious view on duration and a positive stance on credit, aware the emphasis on credit selection has to be increased.

Global and European fixed income

We keep our cautious duration stance on UST and core Europe (and semi-core), but remain active. With some uncertainty on how the US yield curve will evolve, we think investors should actively explore opportunities across the curve to benefit from any tactical move. In Europe, we see steepening opportunities along the curve. However, we stay constructive on Italian peripheral debt amid an ensuing recovery. On inflation, we are positive regarding the US and Europe.

The credit backdrop is improving amid robust corporate earnings, and stronger metrics and financial conditions. We remain constructive on IG (BBBs) and HY (rising stars), and on subordinated debt. We like shorter maturity debt and those where increases in core yields will have a limited impact on prices. However, uncertainly still surrounds us. Thus, we believe selection is crucial and doing it through the ESG lens is even better, not just due to upcoming regulations but also because of some large rotations favouring ESG.

US fixed income

Although we acknowledge the marginal slowdown in momentum, we highlight that much of the economic activity is holding up as vaccination rates gather pace (approval of the Pfizer vaccine). **We maintain our defensive bias on USTs, with a flexible and tactical view based on market volatility and the Fed's indications regarding tapering plans.** We are also committed to our view of a steepening curve amid increased issuance and a long-term inflation regime. TIPS, however, with their yields linked to real rates, appear attractive. **We are optimistic on credit,** but are cautious on beta and sectors where valuations are particularly tight. Furthermore, investors should hold short-dated debt and focus on idiosyncratic factors where selection drives returns. Selective HY credit is good for carry reasons. On the other hand, mortgage markets remain strong due to robust consumer earnings and Fed support.

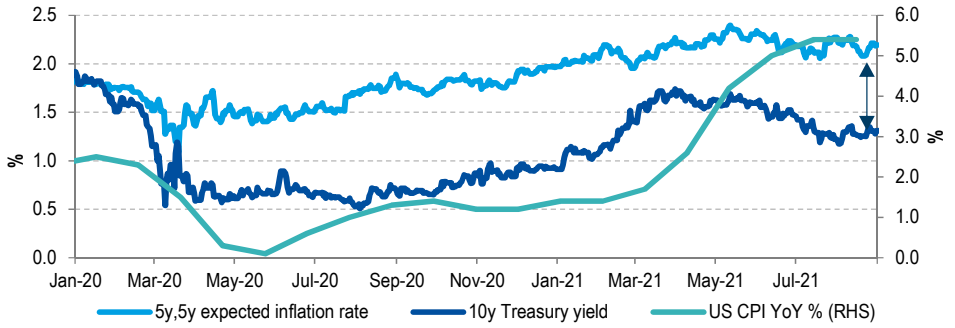
EM bonds

Based on an overall flexible stance, we favour HC debt, with a selective bias towards HY. However, we remain defensive on duration across the board and we are cautious on FX (Fed taper concerns), but are selectively exploring high-yielding FX. In Asia, we are monitoring the resurgence of Covid cases, with a cautious stance on the CNY, but a constructive view on Chinese bonds, given concerns over weakening growth in the country.

FX

We recommend investors fine-tune their convictions, particularly on the USD, but remain positive owing to the Fed's hardening stance. We are also selectively cautious on FX commodities due to weak correlations with commodity prices. However, in EM FX, we upgraded our view on the Turkish lira and the Brazilian real.

US inflation and Treasury yields



Source: Amundi, Bloomberg, as of 26 August 2021. CPI data is monthly.

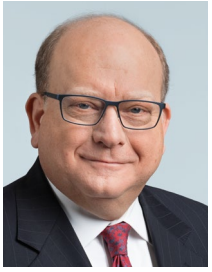
GFI = global fixed income, GEMs/EM FX = global emerging markets foreign exchange, HY = high yield, IG = investment grade, EUR = euro, UST = US Treasuries, RMBS = residential mortgage-backed securities, ABS = asset-backed securities, HC = hard currency, LC = local currency, CRE = commercial real estate,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

EQUITY

Markets priced for perfection deserve some caution

Kasper ELMGREEN,
Head of Equities

Yerlan SYZDYKOV,
Global Head of Emerging Markets



Kenneth J. TAUBES,
CIO of US Investment Management

While growth remains strong, we see some obstacles ahead - momentum fading from current elevated levels and inflation. Investors should avoid areas of excess valuations

Overall assessment

Equities have been supported by strong earnings relative to history and high expectations, particularly regarding cyclicals. Companies are mitigating raw material costs through price increases. However, there are worries over reopenings affected by the Delta variant, economic growth and inflation. Because of inflation, real disposable incomes are being affected, particularly in the US, potentially causing upward wage pressures.

Thus, our focus continues to be on businesses that can sustain margins by passing on input costs to consumers. Overall, we believe earnings still have some room to grow, but valuations (P/Es) may moderate going forward. And, companies with pricing power will be the winners.

European equities

We remain balanced in our approach, focusing on stock selection and companies with strong business models and pricing. Within sectors, we are witnessing a big disconnect, with financials (banks) being very attractive and delivering strong earnings. While we are neutral on energy even as it appears attractively valued, we believe we may see a regulatory push towards renewables to aid Europe's carbon emission goals. We are also constructive on industrials. On the other end, we like defensive sectors, such as telecoms and healthcare. However, we are cautious on tech and discretionary due to less attractive valuations and concerns over luxury demand from China. In fact, the latter issue could have long-term implications for Europe's luxury sector amid China's push to address social inequalities. Stylistically, we are convinced on value and believe the recent pause presents attractive idiosyncratic opportunities.

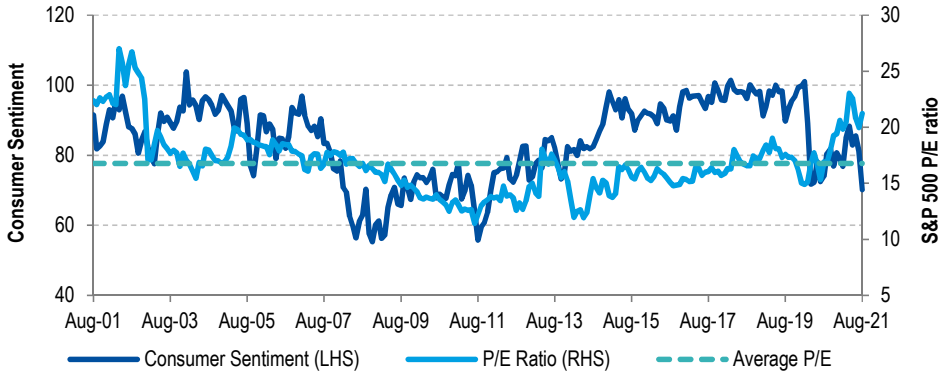
US equities

Corporate margin expansion has been exceptional this year, which is unlikely to be repeated, as the country emerges from lockdowns. On the other hand, the resurgence of Covid infections is temporarily slowing momentum, but this is unlikely to result in a national lockdown and have a huge effect. **Now, inflation, real incomes and consumer sentiment, along with tight valuations and potential tax hikes are the key variables to watch.** On valuations, we are witnessing huge divergences in the market, with some segments trading at heavy premiums vs others, such as value, which is trading at a discount. This convinces us that avoiding leveraged and speculative growth names could be rewarding for investors. However, holding strong value names in financials and energy makes sense as core yields rise. But, we will see a lower cyclical tilt to this rotation vs the past, favouring aforementioned interest rate-sensitive sectors vs consumer discretionary and industrials. On defensives, we see some attractive stories in healthcare, which should do well after a long period of underperformance.

EM equities

Improving vaccination rates and attractive valuations should mildly support EM equities. However, vaccine-resistant virus variants and Chinese regulatory actions, along with its zero-tolerance policy on Covid, may create some headwinds. We are constructive on Russia, India and Brazil. At a sector level, we focus on names with value/cyclical characteristics vs growth, and remain positive on discretionary, especially in countries where recovery is lagging. We remain cautious on chemicals and Chinese financials.

US consumer sentiment and equity valuations



Source: Amundi, Bloomberg. Univ. of Michigan Consumer Sentiment, latest monthly data as of 31 August 2021. BEst P/E

THIS MONTH'S TOPIC

Special Europe: investing in the recovery

by Research Team

In a nutshell

As the European economy is recovering from the largest economic shock of modern history, we are revising our growth and inflation assumptions to the upside. Although the path to recovery is uneven among member states, we believe the EU will see two years of strong growth while inflation should revert below 2%. The ECB should implement a smooth transition from its emergency policies to a "classic" QE and keep policy rates on hold. We see the EUR/USD moving gradually towards 1.15 over 12 months.

In this context, we like periphery bonds and in particular Italian bonds in absolute and relative term. Within the European credit markets, we prefer high beta segments such as subordinated debt and BBBs within IG and high and mid-rated corporates within HY. We reiterate our positive stance on European equities, which brings a cyclical and value tilt to the portfolio. We also highlight the positive impact of NGEU for Central and Eastern European countries.

We downgraded our US and China growth expectation for this year and next

1. The European economy in the context of a global recovery

Annalisa USARDI, *CFA, Senior Macro Strategist Cross Asset Research*

1.1 The global economy on the path to recovery

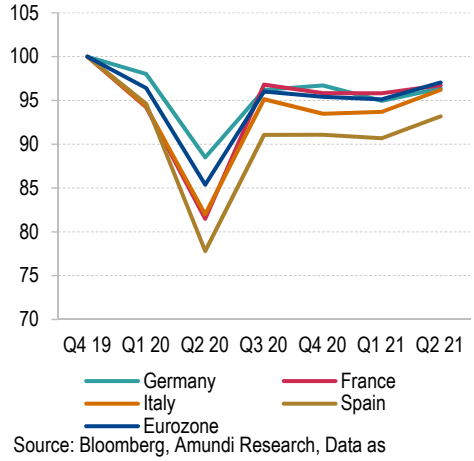
At the global level, **the recovery momentum remains solid,** yet characterised by uneven and multi-speed paths across regions. At the same time, growth momentum slowed somewhat, as suggested by high frequency and PMI data, as activity expansion continued but decelerated in several key economies at the start of Q3.

While the global economic consensus stabilised at high level, global economic surprises gradually declined and are now only slightly positive. **Pandemic developments continue to be a source of uncertainty** and may lead to an increasingly uneven growth path across countries, with a tug of war between vaccination campaigns and virus resurgence. Currently it seems that in the countries with higher vaccination rates, the new wave is somewhat contained, although not uniformly; new cases and hospitalisation rates remain a key factor to watch for risks of new lockdown measures.

Growth forecasts revised down. We expect World GDP to grow by between 5.8% and 6.4% this year and by 3.8% and 4.5% in 2022. China's growth profile has been downgraded as production, consumption and investment all disappointed recently. We now expect Chinese GDP to grow by between 8.4% and 9% this year and between 5.1% and 5.7% next year. US growth has been revised down too within a range of 5.8% and 6.2% this year and 3.3% and 3.9% in 2022. (Amundi's forecasts are available on in the section Macroeconomic picture.)

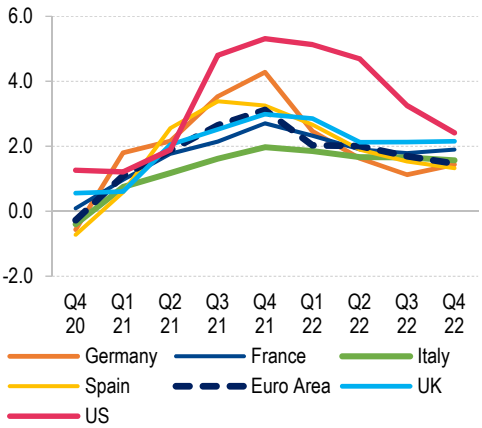
Inflation risk remains. Continued supply constraints and increasing headwinds from supply bottlenecks are weighing on activity and trade in goods. These factors are creating pressure on global inflation, as shown by the recent data. However, recent PMI input and

1/ **GDP Level Q4 2019=100**



Source: Bloomberg, Amundi Research, Data as of end August 2021

2/ **CPI-H Growth, YoY quarterly**



Source: Bloomberg, Amundi Research, Data as of end August 2021

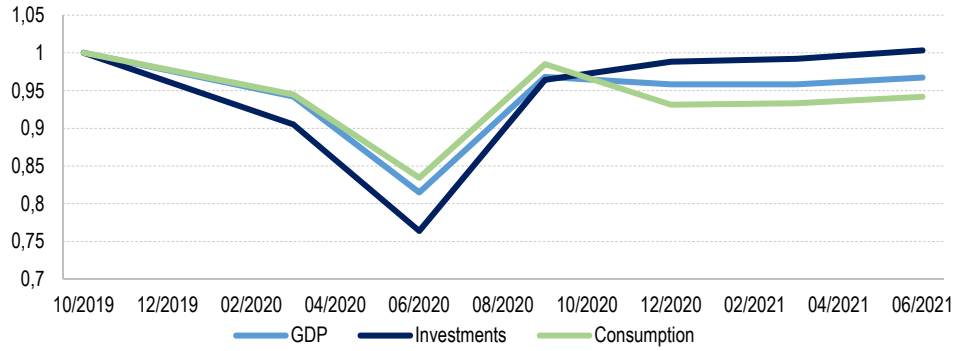
Italy is closing the gap with France and Germany

output prices hinted at some moderation, while remaining very high. We expect inflation to remain above the Fed target over the forecast horizon for the US but the FOMC should stay on hold. Several EM central banks have started to increase policy rates as inflation numbers have been above target.

1.2. The euro area uneven recovery

The euro area economy expanded by 2% in 2Q21, leaving the region's GDP just 3 points below its pre-pandemic level. However, the rebound was not uniform across countries. There were differences in the timing and extension of restrictions in the first part of the quarter, with a delayed reopening in Germany and France. Different impacts from supply and capacity constraints in the manufacturing sector impacted the speed of rebound and are likely continue playing a role in Q3. The pace of growth of Italy and Spain in Q2 was much stronger than the euro-area average. This allowed Italy to close the GDP gap with Germany and France, while Spain narrowed the gap still lags behind (see chart 1).

3/ **France, Q4 2019=100**



Source: Bloomberg, Amundi Research, Data as of end August 2021

1.3. A brighter outlook for growth and inflation

The near-term outlook for the European economy looks brighter than expected in spring. We expect the recovery to continue in a multi-speed manner among member states, but it should benefit from positive spill-overs from strong momentum in internal demand and US growth. Overall, we expect GDP to peak in Q2/Q3 (reopening, vaccination campaign growth momentum and effects of national fiscal support among the key drivers) followed by above potential growth as the NGEU projects kick in (effects from 2022). We expect growth to average 4.7% in 2021, 4.1% in 2022, and 2.3% in 2023, reaching pre-pandemic levels in the first quarter next year. Germany, France and Italy should revert to pre-crisis levels at the beginning of 2022, with similar timing, while Spain should close the gap some time in H2 2022.

Our forecast for inflation this year has also been revised upwards, retaining a hump-shaped profile. The developments in Eurozone inflation partly follow the common trends at play in other DMs: energy is playing a major role in the year-over-year dynamics, together with other base effects on the anniversary of the first lockdown and subsequent rebound. On a monthly basis, the increase in prices due to demand supply friction (bottlenecks, supply disruption, reopening mix) is also at play. Yet, not all countries follow similar patterns, due to idiosyncratic factors, such as the temporary VAT cut in Germany, which is likely to contribute to a significant overshoot in inflation in Q4 this year, and changes in the timing of seasonal sales, which introduced volatility in France and Italy over the summer period.

Contrary to the US, we do not expect wage growth factors to play a major role going into next year. While we expect EA inflation to overshoot the ECB target this year, it should revert below target in 2022. Amundi's average Euro-area CPI headline annual rate assumptions are: 2021@ 2.2%, 2022@ 1.8%, 2023@ 1.6%.

We believe that the sharp rebound of the UK economy in 2021 (from 6.3 to 6.9%) will be followed by another year of strong growth (4.5 to 5.1% in 2022). Growth should then come back below 2.4% in 2023. British inflation should be in line with the euro-area this year and remain moderately above target into 2022. Reopening factors and Brexit related issues explain this higher level of inflation. However we assume that the BoE will stay on hold over the next 12 months.

We don't expect the wage factor to play a major role in the euro area

1.4. Consumption and investment recovery

Consumption and investment followed a different recovery pattern after the collapse in 2020. While private consumption declined during the subsequent lockdowns, Q1 2021 for instance, reflecting a drop in the purchase of both durable goods and services, investment continued to expand, supported by a positive impulse from construction.

Looking at available data for Q2, the recovery in investment seems to be almost completed while household consumption still lags behind, with the recovery in goods more advanced than that in services. As a broader range of spending opportunities becomes available again with the reopening and household purchasing power remaining broadly resilient, we expect the consumption of services to play a key role in the recovery.

Concerning investment, as of Q1, construction recouped almost completely the gap in relation to pre-Covid levels, but machinery and equipment investment still lags behind. Thanks to the boost provided by the new wave of investment driven by the national resilience plans and the NGEU, we expect both construction and fixed capital formation to accelerate and strongly contribute to growth.

2. Next Generation EU – opportunities and hurdles

Tristan PERRIER, *Global Views*

The €750bn (in 2018 prices) NGEU (Next Generation Europe) recovery fund, whose successful negotiation and announcement in 2020 **already played a critical role in defusing political tensions among EU members,** is now functional. This fund goes beyond many previous "red lines" in terms of fiscal solidarity within the EU: issuance of EU debt, transfers in the form of grants, support for cyclical and not just structural economic management.

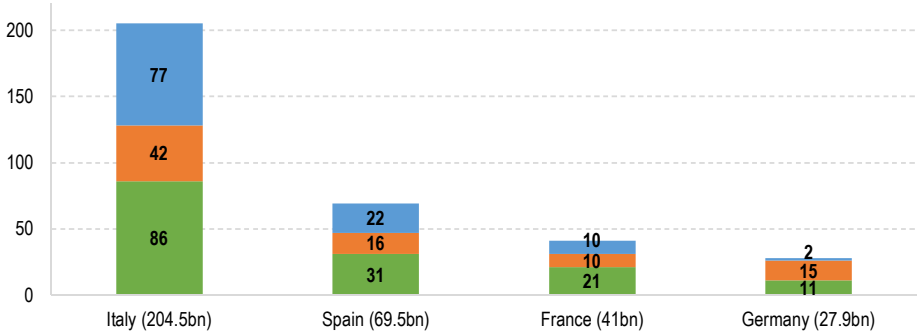
After the resilience and recovery plans (to be funded by the NGEU) of most EU countries (including the four largest) obtained the necessary EU greenlights, the European Commission started issuing the required EU bonds in June and disbursing their proceeds in the form of loans and grants to member states in August. Regarding requests for loans, **there have been significant divergences across governments,** with some eligible countries requesting the entire envelope (such as Italy or Greece), some requesting only part of it (Portugal, Cyprus, Slovenia) and some choosing not to take this opportunity or delaying their decision (Spain).

Depending on the country, the NGEU may account for nearly all (Spain), most (Italy), a significant (France) or a small (Germany) part of the total fiscal effort for recovery planned for H2 2021 and beyond, with the rest represented by country-level resources. **All eyes are on Italy, where NGEU disbursement are nearly 1.5% of GDP for H2 2021 alone,** potentially providing a significant boost to growth, together with a powerful incentive to pursue the much-expected structural reform agenda of the Draghi government. In our projections, we assume that national resilience and recovery plans will start to be implemented in Q4 21, with a significant economic impact starting from H1 2022, and average fiscal multipliers applied to grant disbursements.

NGEU will start to have a full impact in 2022

The NGEU represents a powerful opportunity for the EU to recover from the Covid-19 crisis and potentially boost GDP growth through a cocktail of public investment and reform. However, several programmes may also be slowed by bureaucracy and limited fund absorption capacity at country level. The NGEU's ultimate success or failure will set a precedent that will encourage either the proponents or the detractors of further fiscal mutualisation within the EU.

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



Source: Bruegel Estimates, Amundi Research. Data as at May 2021 ■ Green ■ Digital ■ Others

3. Towards a new E.U. fiscal framework

Didier BOROWSKI, *Head of Global Views*

European fiscal rules were temporarily suspended in March 2020 to allow Eurozone states to implement stabilisation policies. With the end of the health crisis in sight, fiscal policy will needed to be "normalised". But according to what rules? The debate has only just begun.

True, fiscal rules of the Stability and Growth Pact (SGP) will be activated again in 2023. But many economists have called for a revision of these rules, even before the Covid crisis. A revision of the rules does not require a revision of the treaty. It does, however, require close

consultation within the Eurozone, and at least a convergence of views between France and Germany. From this point of view, the outcome of the German elections will be essential.

The criticism of the current rules is not new. Identical numerical thresholds for each country for debt (60% of GDP) and deficit (3% of GDP) have no real theoretical basis. Moreover, these rules have proven to be pro-cyclical and therefore counterproductive (especially after the sovereign debt crisis). Finally, they are based on estimates of structural (i.e. cyclically adjusted) deficits, which are by nature unobservable. Different methods are used to assess them, but none of them is unanimously accepted, which provokes endless debates. Methodological problems are exacerbated by large recessions.

Different rules for each country would be more appropriate

The lines have shifted with the Covid crisis. When interest rates are low (close to their lower limit), the whole policy mix has to be recalibrated. It is striking that this argument was developed earlier this year by Isabel Schnabel (ECB board member). There are more degrees of freedom for a counter-cyclical use of fiscal policy when interest rates are much lower than GDP growth. In other words, **an unconventional monetary policy calls for an unconventional fiscal policy.** But it is unlikely that countries will be able to agree on a reform in the short term. **The current rules are highly symbolic,** especially for the least indebted countries, which believe that they have already made enough concessions when the NGEU recovery fund was set up. It is therefore unrealistic to think that these rules can be abandoned in the short term. Reflection on this issue will nevertheless be pushed by the French EU Presidency in H1 2022, although it will be difficult for France to be heard in the run-up to the general election (April/June).

However, after Covid-19, **concerns about debt-sustainability should encourage governments to amend the rules,** at least in practice. In order to strengthen fiscal credibility in the Eurozone, governments cannot only target a 3% deficit threshold. Other variables such as the primary balance, the debt burden, the level of debt and the ratio of public expenditure to GDP must play a role in the analysis of the efforts required. This would mean in practice that different rules for each country would be more appropriate than a rule based on the deficit alone…

4. The ECB new monetary policy framework

Sergio BERTONCINI, *Senior Fixed Income Research Strategist*

4.1. Implications of the ECB strategic review

The results of the ECB strategic review came earlier than expected and before the July Governing Counsel. Although it did not materially deviate from the most expected outcome, **the strategic review produced an immediate impact on ECB communication,** with a significant shift in the forward guidance on rates at the July meeting. The central bank revised the forward guidance language to put it in line with the new strategy, but to some extent it went beyond that. Although counterbalanced by a lack of quantitative indications, aimed understandably at maintaining judgmental flexibility, a dovish twist was evident.

The ECB is committed to keep rates very low for a long time

The ECB introduced three criteria to start normalising rates (corresponding to the numbers set out below). *"The Governing Council expects the key ECB interest rates to remain at their present or lower levels until it has seen (1) inflation reaching two per cent well ahead of the end of its projection horizon and (2) durably for the rest of the projection horizon, and it judges that (3) realised progress in underlying inflation is sufficiently advanced to be consistent with inflation stabilising at two per cent over the medium term".*

The first two conditions point to headline inflation remaining at or above 2% for the two years following its macroeconomic projections, while the third condition requires that, in addition, core inflation heads towards levels not far from 2% at the end of the projection horizon. As this set of conditions looks far from the numbers achievable in the foreseeable horizon, with this new forward guidance, **the ECB has radically reinforced the commitment to keep its rates very low for a long time.** More importantly, if rates need to remain low for a long period of time, this means longer QE, as the APP is still linked to the first rate hike *"it will end shortly before [the ECB] starts raising the key ECB interest rates."*

4.2. Slow reduction in QE and policy rates on hold

The ECB now needs to address the issue of non-conventional monetary policy tools i.e. APP, PEPP and TLTRO. The main take-away from the Strategy Review points to the **same degree of accommodation, but for longer:** not only a longer period without hiking rates, but also, a longer APP and reinvestment period than expected. This stance looks consistent with the need to fight financial fragmentation, maintain easy financing conditions and make NGEU efforts effective. While 2020 and 2021 saw record levels of public deficits and debt issuance, funding needs should decrease in 2022 for three reasons: (1) the economic recovery will improve the fiscal primary balance, (2) a reduction in debt servicing, and (3) the first NGEU funds become available. This means that **the size of QE will therefore**

be reduced through a lower increase in public debt.

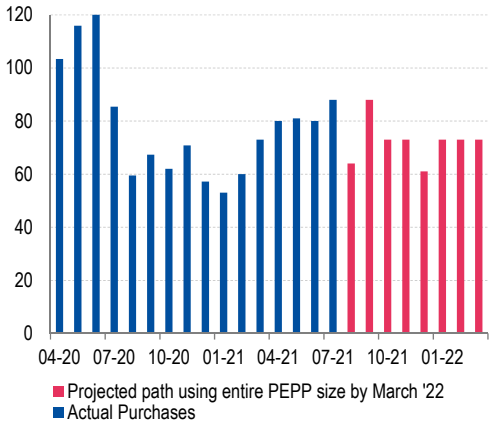
As far as **policy rates** are concerned, the ECB is likely to lag significantly behind both the Fed and the BoE on the road to policy normalisation. **The new forward guidance points to stable rates for the next three years** while we believe the Fed could start normalising rates in 2023. We therefore assume that euro-area policy rates will remain unchanged for our forecast horizon, with the deposit facility at -0.50%.This means there will be a significant time lag from a EUR rates perspective.

4.3. A smooth transition after the PEPP March 2022 deadline

The latest PEPP figures show that the ECB has enough firepower to keep a robust purchase path until at least March 2022. Roughly €580bn of PEPP remains at its disposal, meaning an average purchase of €72bn per month. Adding the APP, the ECB could buy up to €92bn a month (€740bn total), which is not far from the €100bn "higher path" taken in Q2 2021.

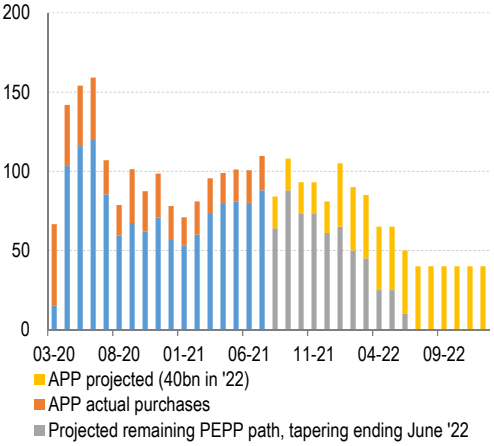
Even if the PEPP and the APP are supposedly two separate tools, they can be combined together in projecting the QE dynamic. Indeed they target the same instruments, although with different weights. After the March 2022 deadline, the ECB has therefore two main options at its disposal to prolong its stimulus: (1) increase the size of the PEPP and extended beyond March 2022, or (2) increase temporarily or permanently the APP as the PEPP ends.

5/ **PEPP monthly path: historical and projected scenario, in EUR bn**



Source: Bloomberg, Amundi Research - Data as of 6 August 2021

6/ **ECB QE: historical and 2022 scenario (PEPP tapering & increased APP) in EUR bn**



Source: Bloomberg, Amundi Research - Data as of 6 August 2021

The ECB's assessment of the recovery from the pandemic will drive its decision whether or not to extend the PEPP, while the new forward guidance seems to favour a higher APP. Assuming the net issuance of sovereign debt will fall in 2022, and the EU's new issuance activity will remain close to this year, monthly QE flows could de facto slow down. For example, an average monthly €60bn, i.e. the remaining PEPP tapered through H122 and a doubling of the current size of the APP, could cover 60% of the net European government bond issuance in 2022 and a significant share of projected EU issuance. Therefore, **a simple increase in monthly APP purchases together with a slow tapering of PEPP** through H1 2022 could get a broad consensus among ECB members.

We expect the EUR to be weaker over the short term

5. FX: Interest rate differential will weigh on the Euro

Federico CESARINI, *Head of DM FX, Cross Asset Strategist*

The sequencing of slowing global growth and the Fed initiating a modest normalisation policy in the months to come is likely to continue to support the USD. We entered 2021 noticing the exceptionality of USD-denominated assets that were realigning in a similar manner to that which led to the USD bull-run in 2018. Whilst US growth and interest rate differentials slowed significantly in the second and third quarters, **we believe that, on balance, conditions remain positive for the dollar.**

We see the EUR/USD moving gradually towards 1.15 (from our previous target of 1.16) in the next 12 months. We believe the currency undervaluation versus its fundamental value, which we estimate at around 1.20, is not enough to compensate both domestic and global factors at this stage.

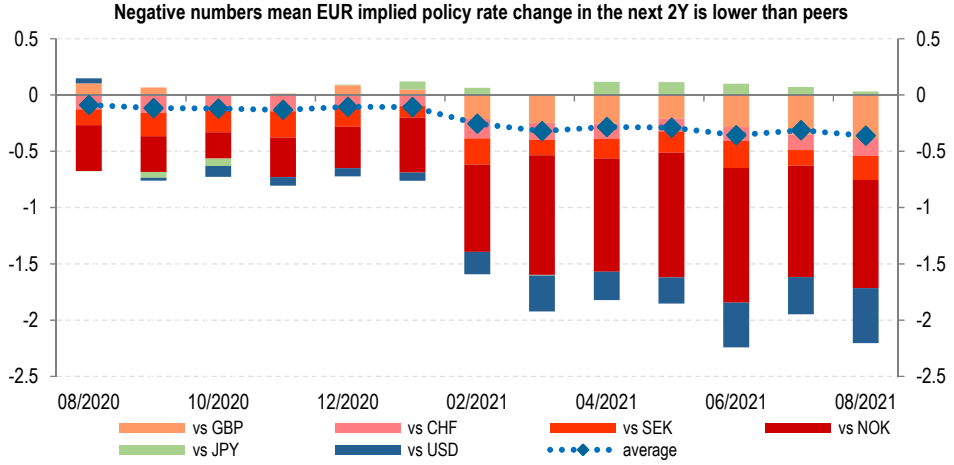
Slowing global growth prevents massive risk taking in the FX market and EUR interest rates are likely to stay low to sustain the recovery. The EUR is the second weakest currency in G10, just ahead of Japan, as no

hike in policy rates has been priced in for the next two years. Conversely, we still expect US interest rates to move higher, thus amplifying the interest rate differential.

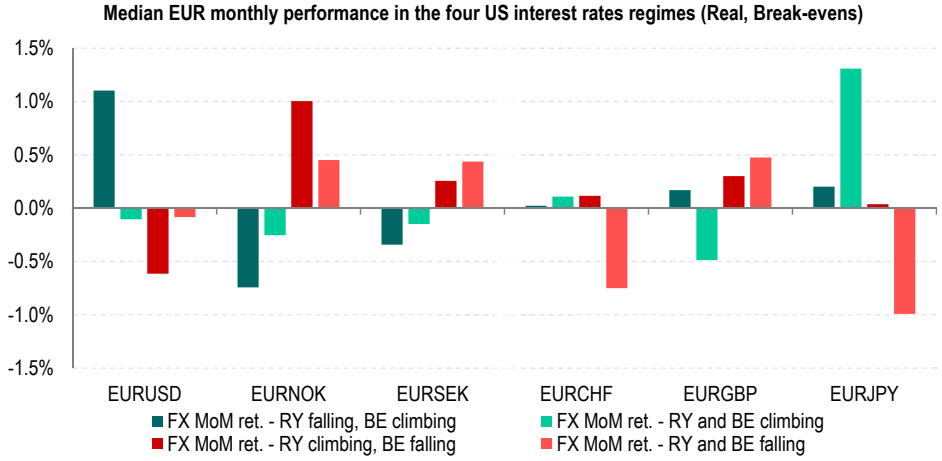
Back in Q1 2021, we argued that the combination of US real rates and US break-evens could capture most short-term fluctuations in G10 FX. As the rise in US rates should favour the real component, we believe that most of the cyclical bets have much less of a clear-cut potential.

In the short-term, we still see the case for a mixed positioning: long USD, NOK and GBP vs. the EUR (on the back of relative hawkish CBs, which we see strengthening vs. the usual safe havens (JPY and CHF). Moving towards 2022, however, we believe a more defensive positioning will be required.

7/ EUR 2Y implied policy rate change vs main currencies



Source: Amundi Research - Data as of 31 August 2021



Source: Amundi Research - Data as of 31 August 2021

6. Looking for relative return in Euro bond markets

Sergio BERTONCINI, *Senior Fixed Income Research Strategist*

6.1. Euro core bond yields should stay low for longer

Bund yields should revert back over the next quarters

In our view, the difference between the ECB's policy and those of the Fed and the BoE is evident and will play a role in impacting the relative trends of the fixed income markets. Indeed, **the ECB is likely to keep low rates for longer,** with QE stimulus persisting for longer (see above). The Fed will taper first, then will focus on raising rates, while the BoE will start raising rates first and then follow with the balance sheet. Despite these different policy normalisation methods, we expect higher US Treasury and UK Gilt yield-to-maturities and a steeper curve than for core EUR government bonds.

We assume that Bund yields will move higher over the next few quarters, supported by the improved fundamental picture, but to a limited extent because of the technical role played by ECB QE. Moreover, supply projections compared with ECB purchases support the EUR bond market at least until the end of the year. As of end-July the EMU-10 countries had already funded two thirds of expected yearly gross issuance and on average 80% of projected overall net funding for 2021. Net issuance after ECB QE is likely to be negative until December 2021 (see chart n°8).

In the UK, we expect long end Gilts yield will move smoothly higher over 12 months.

Within EUR IG we prefer high beta segment

6.2. A positive environment for peripheral bonds

The monetary policy outlook and improving economic fundamentals are supportive for peripheral country debt in 2022 for at least three reasons: (1) NGEU funds will support the recovery while reducing financing needs; (2) continued ECB QE with an increase in holdings as a percentage of marketable debt, will keep debt service costs low; (3) the economic recovery is stronger than expected and should last until 2023.

Among the "big four" countries, Italy seems most advanced with its funding programme, very close to the overall yearly target, thanks also to remarkable volumes of remaining redemptions. According to our projections (see chart 8), ECB demand should be greater than supply in the last five months of 2021. The cash balance of the Italian Treasury remains much higher than historical levels and reached a new peak in July, supporting a more flexible approach to primary market issuance. On the valuations side, Italian debt is among the few with yields above 1%, while half of IG corporate bonds are currently in negative yield territory. **Therefore, we are maintaining our positive stance on Italian government bonds.**

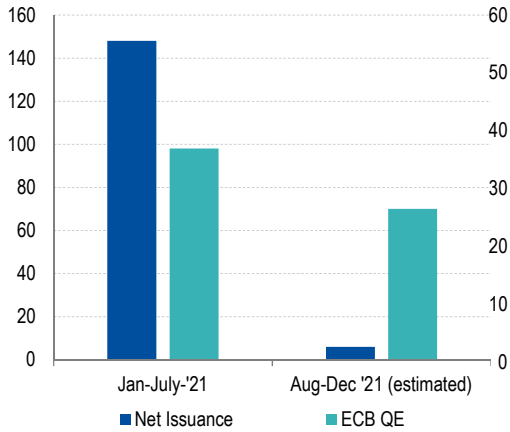
6.3. Improving fundamentals and QE support EUR Credit markets

Improving fundamentals supported by a rebound in earnings and deleveraging, and strong technicals (ECB CSPP) are keeping spreads tight and the asset class resilient to rates and other risky asset volatility. The ECB corporate bond portfolio should reach 35% of the QE eligible debt universe by the end of 2021, after having increased from 20% to 26% in 2020. **The EUR IG credit markets are therefore being supported by steady QE flows** while net supply has remained almost flat over the past quarters. As a reference, in the first seven months of this year, the ECB increased its corporate holdings by roughly €50bn, while the cumulated net issuance of non-financial corporate debt was just €24bn. July saw the lowest EUR corporate gross and net issuance since 2002.

Available bank funding, liquidity buffers and longer debt duration explain these low market funding needs. Looking at the remaining months of the year, net supply from non-financials from August to December should be lower than net CSPP purchases.

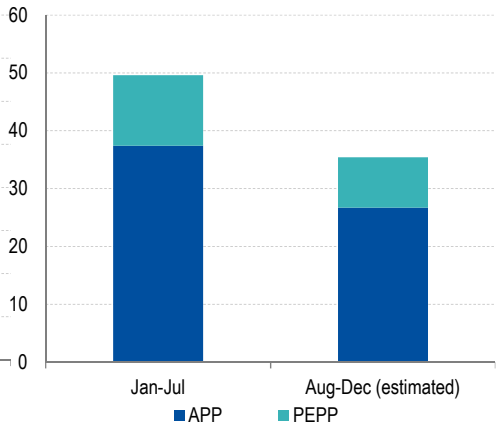
The combination of (1) an improved macroeconomic outlook, (2) easier for longer monetary stimulus and funding, and (3) limited upside on EUR rates, represents a tailwind for the asset class. Default rates are likely to decrease in Europe over the next few quarters, after having already reached a low and an earlier-than-expected peak. **Within the European credit markets, we prefer high beta segments such as subordinated debt and BBBs within IG and high and mid-rated corporates within HY.**

8/ **ECB QE vs Net issuance of Italian debt: Ytd vs remaining estimated volumes, in EUR bn**



Source: ECB, Bloomberg, Amundi Research - Data as of 13 August 2021

9/ **ECB net purchases of corporate bonds, in EUR bn**



Source: Bloomberg, Amundi Research
Data as 6 August 2021

7. Reiterate our positive stance on European equities

Éric MIJOT, *Head of DM Strategy Research*
Ibra WANE, *Senior Equity Research Strategist*

Asset class views: The stock markets have rallied strongly since March 2020 (supportive policy mix, vaccination progress, impressive earnings rebound, etc.). Still, after an almost twofold increase in the MSCI World AC and ahead of the well-flagged Fed tapering, **the case for global equities is becoming more neutral.**

Valuation: It is certainly true that robust 2021 results will absorb some of the increase in

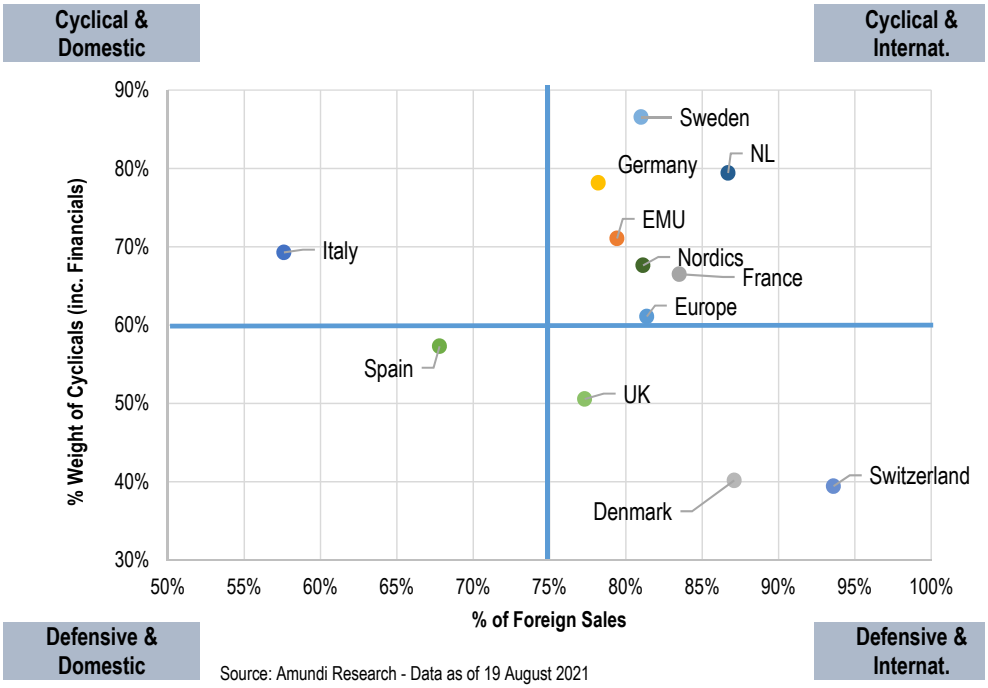
A relative preference for EMU within Europe

valuations that occurred in 2020. But as the pace of global EPS growth is seen to normalize from a record +45% in 2021 to a muted 8% in 2022, **the current forward P/E of 18.6x remains quite rich** compared with the pre-Covid era (13x to 16x range).

Relative preferences: While the US is a long-duration and quality play, it is also expensive, with an almost record-high cycle-adjusted P/E premium versus Europe. If we assume that GDP growth will decelerate but remain above potential until 2022**, it would make sense over a 12-month horizon to favor the more pro-cyclical and relative value play of the two, i.e. Europe.** Within Europe, the EMU - an affordable cyclical option and value case **- is a natural candidate compared to the UK** (relatively cheap but more defensive and low beta market).

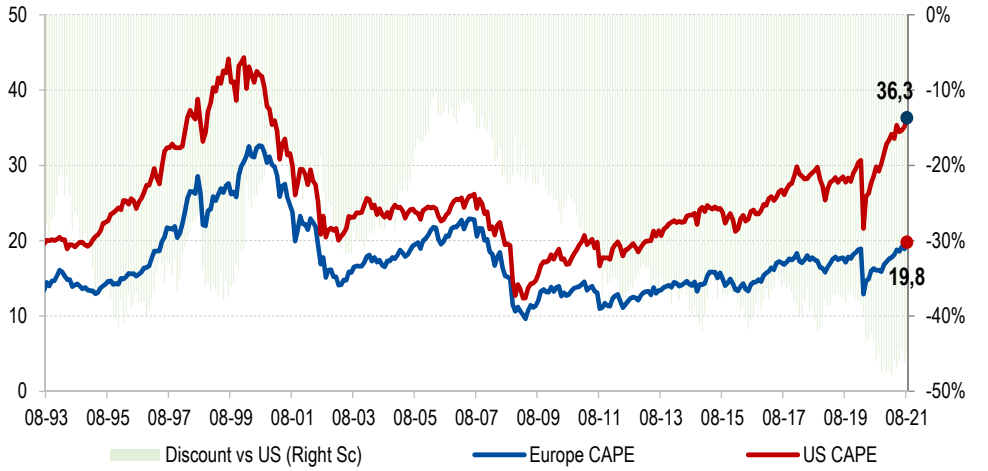
Main risks: Will inflation subside once base effects and bottlenecks dissipate or prove stickier than anticipated? This will determine the timing and extent of the tapering and how bond yields react. **Covid is the other unknown.** Even if its impact on the AEs economy is much lower than it used to be, the timing of an almost full normalization has become hazier with the Delta variant. A combination of lower-than-expected growth and bond yields would jeopardize our rather constructive view.7. Reiterate our positive stance on European equities

10/ **Exposure MSCI European indices**



Source: Amundi Research - Data as of 19 August 2021

11/ **MSCI Europe and USA Cycle Adjusted PE**
Europe at an almost all-time high discount



Source: Amundi Research - Data as of 19 August 2021

THIS MONTH'S TOPIC

Europe will have to cooperate with Russia on the Afghan situation

8. Europe geostrategic dilemmas

Pierre BLANCHET, *Head of Investment Intelligence*

The end of US military presence in Afghanistan leaves the Europeans with a first strategic dilemma of a cooperation with Russia. Although China seems to play an active role in the future of the region, it is unlikely to protect European interests whereas Russia could. But at the same time, **Russia's growing influence at the borders of Europe** is a source of concerns for the E.U. Indeed, the conflict in Ukraine/Crimea remains unsettled, and Belarus is moving towards more integration with the Russian Federation while Baltic countries always felt the pressure at their border. Afghanistan would be added to the list of situations such as Syria and Irak where the E.U. needs Russia.

The second dilemma relates to Turkey, which is the only NATO member with a muslin population (moreover sunny) and has a historical and ethnical relationship with Afghans. Turkey could play a key role as a mediator and eventually provide a lifeline for the new regime, while its relationship with Europe has deteriorated recently. **The third dilemma is about Afghanistan itself.** Would the Taliban be unable to monitor Al Qaeda and terrorist groups, or in case they would themselves be a support for international terrorism, Europe will certainly be a target and therefore will have to react. Lack of preventive actions in the previous decade has caused hundreds of casualties. Another wave of terrorism on European ground will not be acceptable. The fact that NATO allies were not involved in the US exit was already a blow for European leaders, and the future of Afghanistan might become an equation with too many unknown.

More generally, **the Afghan crisis shows how dependent Europe is on the United States,** especially when it comes to conducting large-scale military operations outside its borders. European defence is almost non-existent. This crisis acts as a wake-up call for European leaders who need to strengthen their military cooperation if they want to give substance to the concept of "strategic autonomy".

Moreover, **Europe could easily be trapped into the US-China "cold peace"** and needs to define a credible alternative to better protect its own economic and strategic interests.

Asset classes	Investment views	Targets or favoured assets
Money Market	ECB policy rates unchanged in the forecast horizon	ECB rate -0.5%
FX EUR	EUR slight depreciation	Q4 2021 EUR/USD 1.16
		Q2 2022 EUR/USD 1.15
Euro Sov Bonds	Stay short duration on core	German 10y Bund yield target [-0.4; -0.2]
	Long periphery vs core	Long BTP vs Bund spread
EUR Credit	Positive on EUR Credit on improving fundamentals and ECB support	EUR IG: high beta segment, subordinated debt and BBBs
		EUR HY: mid rated corporates
European equities	Positive on Europe vs US: pro-cyclical and relative value	Favour Eurozone equities
EM CEE	Sovereign bonds: limited space for yield tightening, despite inflation heading down	Short duration Hungary
		Neutral Poland & Romania
	Equities: cautious stance on valuation and earnings growth expectations	Negative Czech Rep & Poland (versus Russia & Turkey)

A busy political agenda for Europe

by Tristan PERRIER, *Global Views*

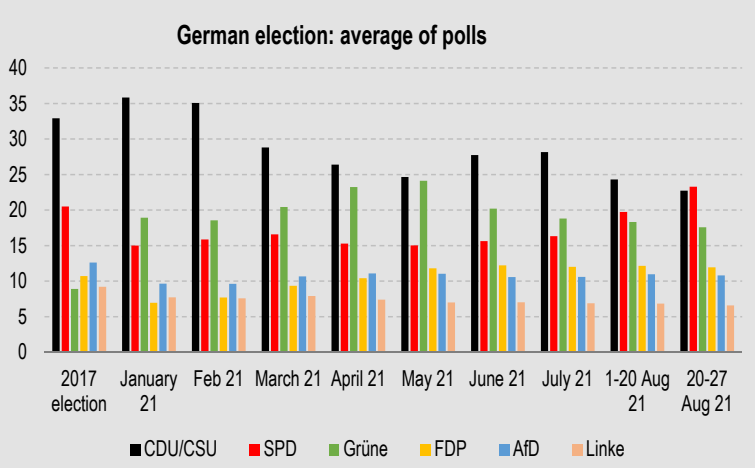
■ Germany

The German federal election, expected to be held on 26 September 2021, is unlikely to be a major short-term market mover. It is true that the scenarios for the next government coalition (which may take some time to build) are quite open, even more so as some polls now unexpectedly show the SPD (center-left) ahead of the CDU/CSU (Merkel's center-right) and the Greens. However, the agendas of these three parties, two of which will certainly be the senior and main junior partner of the coalition, do not deviate radically from German policies so far (especially when it comes to European policies).

Moreover, the **need to build consensus within the government coalition** (that could also include the pro free-market FDP or, less likely, the left-wing Die Linke), together with the **powerful checks and balances of the German political system**, also limit the potential for substantial change.

Nonetheless, these elections are likely to be closely followed as they will lead to **a new German Chancellor** (arguably Europe's top political position) taking office after 16 years of Merkel. This new Chancellor will no doubt have a pivotal role to play in shaping further institutional developments of the EU and euro area, and in keeping these blocs together should any new systemic continental crisis occur. This new German leader will probably be either SPD's Olaf Scholz (Germany's current finance minister, probably the most proven European profile of the 3) or CDU's Armin Laschet or the Green's Annalena Baerbock.

Moreover, beyond a lot of commonality of views and little potential for abrupt change, **there are nonetheless differences across** mainstream German parties that mean that the nature of the coalition may matter over time, both for Germany and for European affairs. Notably, **the larger the role of the Greens and/or the SPD in the coalition, the more likely it will be that Germany takes a more gradual and tolerant approach to fiscal normalization** (after the large Covid-related deficits) both at home and in the rest of the Euro area. **At the margin, the Greens and SPD are likely to be less opposed to potential new steps towards European fiscal union** (against the backdrop of the NGEU) than the CDU and FDP.



Source: INSA, Vorschungsgruppe Wâhlen, Allensbach, YouGov, Kantar, Forsa, Infratest dimap, Trend Research, IPSOS, GMS, Redfield and Wilon Strategies, Wikipedia.org, Amundi Research - Data as of 30 August 2021.

A coalition that would include the leftist Die Linke party (a scenario that looks less unlikely than a few weeks ago now that the SPD is ahead in the polls and does not rule out teaming with Die Linke) **may be seen as the major risk,** as it **could theoretically open the door to market-adverse policies** (such as a reversal of previous German supply-side reforms). However, even in that case, Die Linke's influence within the coalition would probably be limited and the checks and balances effective.

Including the far-right Eurosceptic and anti-immigrant AfD party in a government coalition is currently not an option considered by other parties.

■ 2022 French elections

After the German election at the end of September 2021, the next major scheduled political event in the Euro area will be the French electoral cycle: a two-turn presidential election on 10 an 24 April 2022, followed by a two-turn legislative election on 12 and 19 June.

At this stage, President Macron and Marine Le Pen (far-right) are ahead in the polls for making it to the 2nd turn, with Macron projected to win it in the end (note that Macron can now claim a relative success at least for the vaccination campaign). However, it is still very early and other parties (notably the mainstream right-wing, that could still make a comeback) are yet to pick their candidates.

All in all, this French election could trigger a bit more market stress than the German one. This is due to the strong far-right and to the unpredictable nature of the two-turn system (if the vote is very fragmented, an unexpected candidate could in theory make it to the 2d turn). However this stress should be less than in 2017, as, unlike then, no major candidate has Frexit on his/her agenda. Mind also that, while this has never happened under the current constitution (since 1958), it is theoretically possible that the elected president fails to win a majority for his/her party at the legislative election, which would then trigger a search for a coalition.

THIS MONTH'S TOPIC

Central Europe challenges and opportunities

by Karine HERVÉ, *Senior EM Macro Strategist*

Central and Eastern European (CEE) countries, together with Southern European countries, were the main beneficiaries of the 2021-2027 budget and the new NGEU (Next Generation EU) recovery fund. CEE countries submitted their national programmes to the European Commission, expected to analyse and approve them over the summer before submitting them in turn to the Council for validation. As a result, funds should start rolling out in August to a number of countries whose plans have already been greenlighted by the Council (Croatia, Cyprus, Lithuania, Latvia, Slovenia, Slovakia). The process is under way for other countries, except for Poland and Hungary, which have seen their applications pushed back due to various rule of law violations, triggering a battle between these countries and the European Commission that could last several months (especially in Hungary's case).

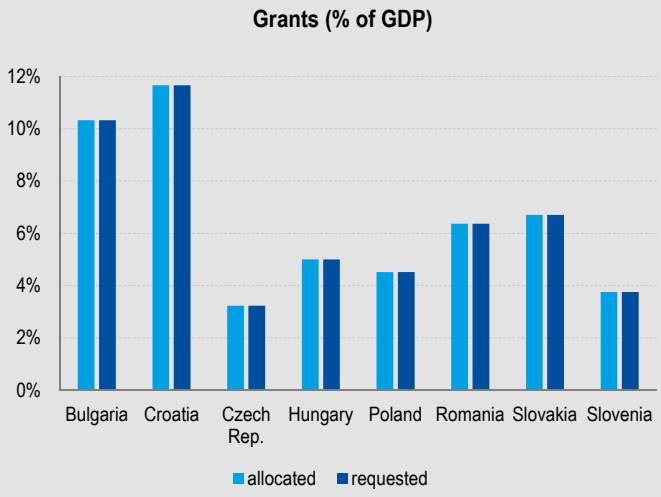
The funds paid out by the NGEU make up roughly 10% of projected average GDP for CEE countries from 2021 to 2027. Croatia and Bulgaria are the top beneficiaries in the region, in terms of % of GDP (18%). CEE countries have applied for all allocated grants but less than one-third of loans, with the exception of Romania which asked for the full package. At this stage, CEE applications represent an average of 4-8% of GDP estimated over the 2021-2027 period (see charts). For the time being, CEE countries have not asked for loans, but they have until August 2023 to do so and there is every reason to think they will once the grants have dried up. They can also wait to apply for loans in the hope that if the grants are not all allocated, they can get more, as the European Commission tends to be little inclined to give net contributors their money back.

In recent decades, CEE economic growth has been driven by traditional industry, export momentum, FDIs, low labour costs and European funding. This model is losing its effectiveness, however, and **CEE countries are on average under capitalised** compared to their other European counterparts with a capital stock estimated to be 60% smaller than Europe's five largest countries. Furthermore, labour costs have been continuously on the rise in recent years and the region's predominant industry (automotive) will be increasingly impacted by automation going forward. Against this backdrop, European funds focused on the energy transition, digitisation and research promotion sectors are arriving at just the right time. For one thing, 30% of funds are required to be allocated to climate change projects, which in light of the high carbon intensity of CEE countries is like manna from heaven.

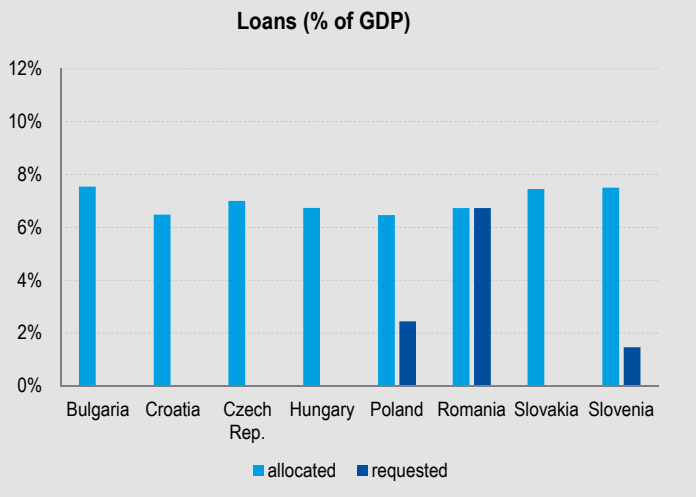
Multiple estimates have been calculated on the impact these funds can have on real GDP growth. According to a Commission study, NGEU funds are expected to boost European Union growth by 1.75 percentage points (pp) in 2021 and 2022, and by 2.25 pp in 2023 and 2024. Unfortunately, these estimates are undoubtedly on the generous side, as they are based on the assumption that 100% of grants and 50% of loans will be used, which is not currently the case as we mentioned above. Other independent analyses show that **the impact could end up being very high (between 0.6 and 1.6 pp per year) in Bulgaria, Croatia and Romania** – all of which asked for asked for larger sums than other countries in GDP percentage terms, and because they have substantial infrastructure requirements – as opposed to 0.2 to 0.6 pp in Czech Republic (low absorption rate) and Hungary (inefficient fund spending).

There are some risks surrounding these estimates, however. First, **the absorption rate of European funds in public sector investment is relatively low,** sitting at 30% for CEE countries (for the 2014-2020 budget). Second, taking past plans as a reference, even if the absorption rate is high, **there is a 3-year lag before all the funds are used.** Lastly, at least 30% of funds have to be allocated to the climate transition and 20% to the digital transition, the problem being that it may be difficult to find enough projects in these categories.

Regardless, there is no doubt that European funds are an exceptional boon for these countries and their continued economic development in the European Union.



Sources: European Commission,National Government, Amundi Research - Data as of 05/08/2021



Sources: European Commission,National Government, Amundi Research - Data as of 05/08/2021

SPECIAL EUROPE Q&A

You asked, we answered

by Research Team

As a complement to the Special Europe report, we try to answer some of the key questions often asked.

Q1. German elections. What can we expect?

No party seems to be able to secure a majority in the Bundestag

With less than a month to go before legislative elections (26 September), the game is particularly wide open. The Greens have gained ground, but no party seems to be able to secure a majority in the Bundestag. It will probably take a coalition of three parties to form a majority. At this stage, the central question is whether or not the conservatives will be part of the future coalition.

There is no natural successor to Angela Merkel. The most popular candidate to succeed her is Olaf Scholz, the current Social Democrat finance minister. However, the chancellor is not directly elected but chosen by parliament. Armin Laschet, president of the CDU, has less experience but will have a larger pool of votes in the Bundestag and therefore has a better chance of succeeding Angela Merkel than Olaf Scholz or Annalena Baerbock, the Green candidate.

To date, the two most likely scenarios that are emerging are: (i) a so-called Jamaica coalition (between the conservatives (black), the Greens and the liberals (yellow); or (ii) a coalition between the Reds, the Greens and the liberals. A "leftist" red/green/left coalition is much more unlikely.

It will probably take time to form a new coalition. Let's remember that after the September 2017 elections, it took more than four months to reach a "coalition contract" between the CDU and the SPD and another month to get it ratified by SPD, something that hadn't happened in Germany since WWII!

Moreover, Europeans have too many illusions about the Germans' ability to change their strategy following an election. Important decisions are taken by consensus in Germany, and change must unambiguously reinforce the country's stability to be approved. And, in addition, major changes in European affairs must be adopted by both houses of parliament (the Bundestag and Bundesrat). The SPD and the Greens certainly support the idea of greater financial solidarity in Europe. This argues in favour of more risk sharing within the EU. But the participation of the Greens in a coalition would not change the situation radically, as they have moved closer to the centre. Moreover, the liberals have a notoriously tougher position on financial risk sharing.

To sum up, the elections on 26 September are an important step for Germany (with the end of the Merkel era) but will not lead to an upheaval, either in terms of economic policy or even at the level of the European institutions. At the margin, however, the German doctrine on the new fiscal rules under the Stability and Growth Pact could evolve, depending on the coalition in power and the new chancellor.

Q2. Central banks: what's next?... Wait and see!

The Fed and the ECB continue to see the acceleration in inflation as a temporary phenomenon

For the Fed and the ECB, the terms of the debate have changed little since June. It is true that inflation forecasts for 2021-22 have been revised upwards in the US and the Eurozone. But overall, the Fed and the ECB continue to see the acceleration in inflation as a temporary phenomenon.

Following their strategic review, their reaction functions have changed. Both CBs are able to justify a more accommodative monetary policy than in past recoveries, at least as long as inflation expectations remain well anchored.

The Fed and the ECB are more concerned about economic activity than inflation, with the possibility of a premature slowdown in growth, due to a resurgence of the pandemic. There is a loss of momentum in global growth. In the US, the Jackson Hole meeting confirmed expectations. The Fed will start tapering before the end of the year, but at a gradual pace, in line with expectations. The Fed aims to reduce the degree of monetary accommodation as the US output gap closes. But the Fed intends at the same time to dissociate tapering from rate hikes. It clearly does not want to tighten monetary and financial conditions. It has learned the lessons of the 2013 taper tantrum and its impact on the markets. Hence its particularly cautious communication.

In the Eurozone, the terms of the debate are somewhat different. Firstly, because the economy as a whole is less advanced in the cycle in the Eurozone than in the US; second, because inflationary pressures are less pronounced in the Eurozone than in the US; and third, because the asset purchase programmes are calibrated on different criteria. In particular, PEPP was designed as an emergency programme, directly linked to the pandemic and its impact on the economy. The uncertainty about the Covid and the Delta variant will reinforce the ECB's caution in the short term. PEPP continues until March 2022, and it may seem premature for the ECB to specify what it will do afterwards. It will probably want to leave the door open for several options (such as an extension of PEPP if the health situation requires it). However, the drop in sovereign issuance expected next year will allow the ECB to reduce its securities purchases in 2022 without causing a tightening

SPECIAL EUROPE Q&A

of financial conditions. One way or another, the ECB will manage to justify a rebalancing of its securities purchase package in order to carry out a smooth tapering. Financial fragmentation remains high in the Eurozone and it is essential to maintain accommodative financial conditions to complement the NGEU stimulus fund. The prospect of a rate hike remains very remote.

Central banks have an even more accommodating bias as without their monetary policies fiscal policies on both sides of the Atlantic would be difficult to sustain. Whatever central banks may say, they have entered an era of fiscal dominance.

At this stage, the only thing that could change the situation in the US and Europe is a sharp revision of inflation expectations. While it appears that inflationary pressures may last longer than expected, due to disruptions in value chains, we do not see upward pressure on wages at this stage. This is probably the most important variable to watch.

Q3. Will Europeans' excess savings turn into consumption?

Savings are unlikely to fall far below pre-crisis levels

Much has been written about the potential of excess savings and the upside risks to growth posed by stronger household consumption. According to data as of Q1 21, excess savings in the Eurozone amount to 8.8%-9% of 2019 GDP. We may expect some normalisation of the savings rate to close to pre-crisis trends. Yet, the assumption of a strong and persistent boost from excess savings into consumption would require a savings rate significantly below pre-crisis trends over a sustained period – which is highly unlikely.

The distribution of excess savings created during the crisis has been skewed towards higher-income households, which are slower to spend savings and more prone to move excess savings towards asset investment rather than consumption, putting at risk the overly optimistic outlooks already highlighted for several countries. Moreover, the fact that the virus is becoming a persistent source of uncertainty in the medium-term is adding to the fact that households are less confident in their personal financial situation, due to the uncertain timing of the withdrawal of furlough schemes and employment outlook. Given the low visibility around future social restrictions, we are assuming that the release of pent-up demand will play a positive, if moderate, role in boosting the recovery in the quarters ahead.

Finally, consumption may be limited by the so-called "Ricardian equivalence effect" which may play an even greater role, with households becoming less inclined to consume their excess savings in light of the expected (or announced) tax increases in the years ahead. This is particularly true in countries with high public debt levels, which will eventually have to comply with EU fiscal (new) rules.

Q4. What are the implications of EU issuance for the Eurozone bond market?

The EU will be one of the biggest players in the European primary markets

On the year to date, the EU has issued more than €100bn, €50bn of which was under the SURE programme, €45bn under NGEU, with the rest under other standard programs (EFSM/MFA). While SURE bonds kept the primary markets busy in the first five months of the year, the start of NGEU issuance proved very successful and intense, with the EU placing four NGEU issues with much higher outstandings than SURE or other EU issues in just one month between mid-June and mid-July.

The EC plans to issue at least €80bn of EU bonds under NGEU, most of the expected issuance left for the remainder of the year (roughly €35bn). In the September review of planned funding for the year, this target could be revised up following the recent quick disbursement delivered to countries under the RRF programme. In terms of maturity, issues have been fairly well distributed across the curve, although the 10y area dominated, thanks to the €20bn issue in June: the longest segment of the curve has been targeted the most, as three of four NGEU bonds issued so far were in the 10yr-30yr maturity bucket. Although no dates have been set yet, in terms of issuance format, auctions should start in September, as the EU plans to combine syndications with auctions. As we know, NGEU bonds will see larger outstanding volumes than SURE bonds and will benefit from an auction system that will provide them with more secondary market liquidity.

In the remaining months of 2021, the EU will be one of the biggest players in the European primary markets, and high-rated sovereigns mostly ahead with their gross and net planned yearly funding. According to the figures for end-July, Germany and France have made good progress in yearly net funding, particularly in long-dated supply.

A look into 2022 sees the EU likely to play another remarkable role in the issuance of new debt, as most of the cash flows for the grants and loans of NGEU's RRF are expected to be concentrated in 2022 and 2023. The volume of issuance next year is estimated to be close to this year, in the region of €140/150bn, meaning that net issuance in absolute terms will be stronger in relative terms vs. the sovereign segment, as public deficits and net funding are likely to fall from their 2020-2021 peaks. At the same time, we expect the ECB to continue allocating an adequate share of its overall QE to supranationals and agencies in 2022, and to continue targeting high average duration in its purchases of EU bonds, in line with the recent trend shown, ultimately supporting this segment.

THEMATIC

US and European HY default rates: recent and expected trends

Sergio BERTONCINI,
Senior Fixed Income Research Strategist

Debora DELBO',
EM Macro Strategist

Claire HUANG,
EM Macro Strategist

Persistent supportive funding conditions and the improved macro picture are consistent with a current and expected benign picture for US and European default cycles, which are likely to remain on a downward trend in the coming months. Emerging markets' high yield corporate default rate remains quite low and we expect a further decrease in the next month. Higher risk in China, in particular in the property sector. Beijing will continue with financial de-risking and reducing housing sector leverage but systemic financial risk will be prevented.

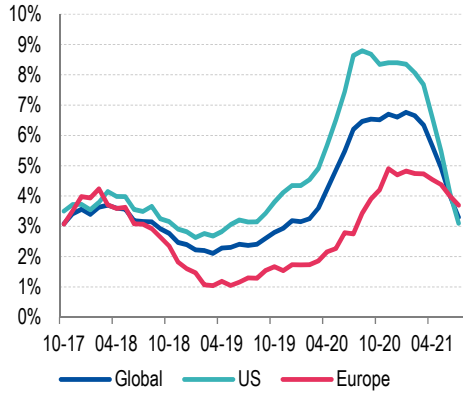
Global default rates keep falling significantly, thanks to a strong economic recovery, abundant liquidity in the capital markets and persistently low cost of debt servicing. According to the latest figures from Moody's, the trailing 12-month global speculative-grade default rate was 3.3% at the end of July, the same as the pre-pandemic level, at the end of February 2020. July also marked the seventh consecutive month in which the global rate had declined since hitting a cyclical peak of 6.8% in December 2020. A look at trends by geographical area over the past few months shows that the speculative grade default rate has fallen more rapidly in the US than Europe, down from higher peaks, and finally matched the remaining gap with Europe in June. In July the US default rate finally fell to 3.1% from 4.0% in June, while the European default rate fell to 3.7% from previous month's 4.0%. In first half of this year the default number totalled 28 companies, roughly just a quarter of the 114 defaults that occurred in the same period last year (H1-'20).

As we have often underlined in previous publications, this cycle was mostly concentrated in the lowest-rated and most vulnerable names. Thanks mainly to prompt and effective policy intervention, BB and B-rated default rates have remained very low by historical standards, as no credit crunch took place and financial conditions remained supportive. Just as CCC default rates drove this cycle upward, the recent downward move has been led by the lowest-rated segments. Over the past few months their default rate has roughly halved from cyclical peaks above 30%, while other rating categories are already close to being quite low.

Moody's expects the downward trend to continue in the next few months and then to stabilise below 2% by the end of the year and in H1 2022. In short, the global default rate should keep falling, albeit at a slower pace than in H1, and the latest 12-month projections by the rating agency for US and European HY default rates point to 2% for both areas, while forecasting even lower levels by the end of this year, respectively at 1.5% and 1.8%. Moody's baseline scenarios for the two areas assume ongoing supportive funding conditions and an improved macro picture. In our view, this benign picture is consistent with distress ratios and other indicators of financing conditions remaining at quite favourable levels by historical standards and is consistent as well with macro and micro prospects. In this respect, a look at European market sees supportive readings from the latest bank lending standards survey published by the ECB and encouraging trends in HY primary market. On one side, loans standards applied by banks to non-financial companies have improved in the last two quarters, while, on the other, a remarkable volume of refunding activity through bonds issuance has made it possible for many companies to increase the average duration of their debt at very low costs. Fundamental trends keep showing supportive earning growth, ultimately being consistent with on-going improvement in credit metrics and lower default rates.

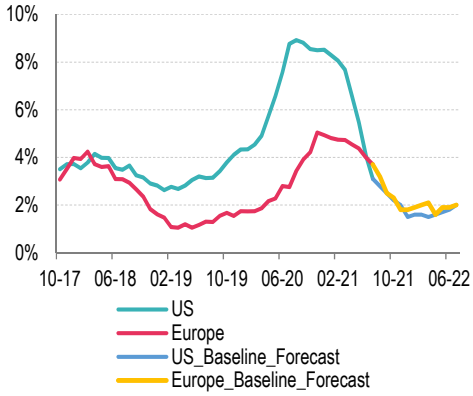
A look at the European market sees supportive readings from the latest bank lending standards and encouraging trends in the HY primary market

1/ **Global HY Default rates (Moody's)**



Source: Moody's, Amundi Research - Data as of 13/08/2021

2/ **US and Europe HY Default rates: actual and projected by Moody's**



Source: Moody's, Amundi Research - Data as of 13/08/2021

THEMATIC

The emerging high yield corporate default rate is stabilising, at slightly above 3%

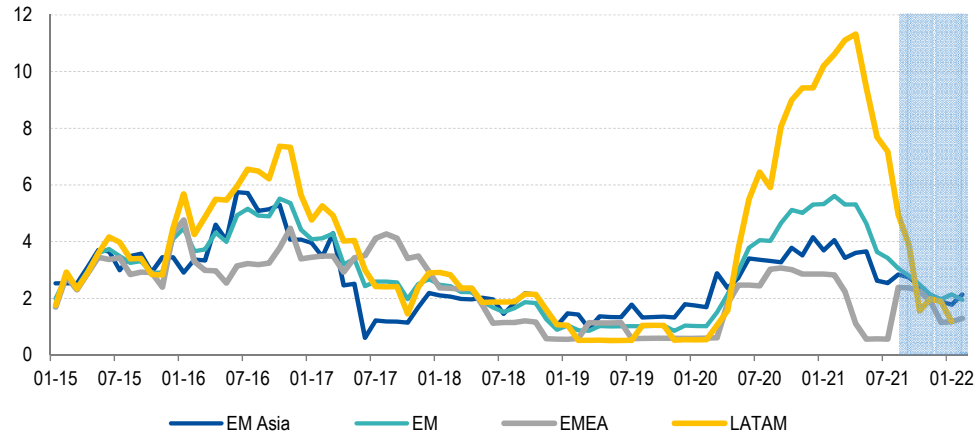
Internal calculations see GEM HY corporate default rates decreasing further on a six-month horizon in the range of 1.8%-2.3%

Risk perception remains higher in China, in particular in the property sector. We expect, however, Beijing will carefully prevent systemic financial risk

Emerging markets' high yield corporate default rate (source: Bank of America) **is stabilising at slightly above 3%** (3.4% in August from 3.6% in July). The region with the worst default rate is Latin America (7%), particularly Argentina and Mexico. The distress ratio in Latin America is close to 10.6%, but excluding Argentina is it only 2%. EMEA, on the other side, is the safest region (with a default rate of 0.56%).

In terms of forecasts, our internal calculations see GEM HY corporate default rates decreasing further on a six-month horizon in the range 1.8%-2.3%. Country risk perception (CDS) has stabilised, but spreads are not showing any further improvement, and this is visible in the distress ratio, which has moved up again to 17.6% in August from 15.5% in July. GEM earnings growth expectations are going to move down on a 12-month horizon from the current 18% to 16%, due to the slowing down recovery, which leaves less room for further pickup. On the positive side, leverage is improving for GEM, in both net (4.5) and gross (6.3) terms. Global financial conditions remains quite supportive and volatility is low.

3/ EM HY Default - forecast



Source: Bank of America, Amundi Research - Data as of 23/08/2021

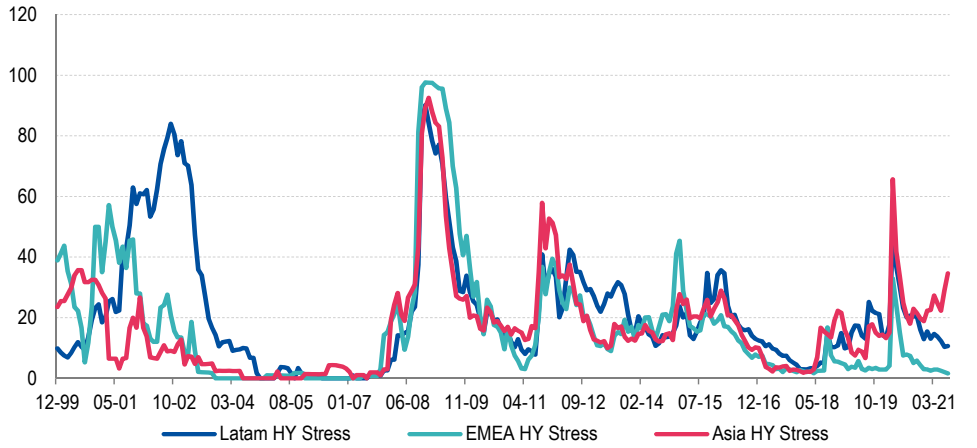
At the regional level, as we have seen, the Latin America default rate is still high, mainly in Argentina. We see some improvements in the next six months (default at 1.5%-2%) thanks to not excessive funding requests and a further recovery in earnings growth (Latin America is still a laggard).

In EMEA and EM Asia, default forecasts remain contained and not very far from current levels.

EMEA is the region where both current default rates (0.56%) and six-month forecast rates (1.2%) are lower, thanks to very contained leverage (net debt/EBITDA ratio at 2.7 and gross at 4) and distress ratios (1.6%).

On the other side, emerging Asia remains the region with the highest forecasted default rates on a six-month horizon, at slightly above 2%. In this region, the spread-to-worst increased further last month, and the distress ratio is mounting again (to 34.6% from 29%). Risk perception remains high mainly in China, in particular in the property sector, where spreads have widened. The case of Evergrande illustrates that Beijing will continue with financial de-risking and reducing housing sector leverage, but will carefully prevent systemic financial risk. In light of weakening growth momentum and with inflation risks at bay, we expect China's overall policy stance to turn more decisively to the dovish side.

4/ Distress ratio



Source: Bank of America, Amundi Research - Data as of 23/08/2021

THEMATIC

Job market integration within the Eurozone[1] from 2008 to 2020: a challenge for the ECB?

Valérie LETORT,
Global Views

The shock to the Eurozone job market in 2020 was considerable. Hardest hit were southern countries, young people and women. We discuss below these various factors of market fragmentation in the largest Eurozone countries. In addition to aggregate employment figures, major central banks are looking more and more closely at the structure of employment (by gender, skills and country), as excessive job market fragmentation could undermine medium-term price stability. This includes the ECB. The lack of convergence could be one justification for keeping monetary conditions accommodative for a long time to come.

Gaps are still wide between countries in employment

Gaps are still wide between countries and are widening in employment[2]. Each crisis is the occasion of a new divergence shock. The one that occurred in 2020 was especially hard-hitting, and the one that occurred in 2008 was only partly made up by periods of growth.

There is an even wider divergence in youth employment[3], and crises have an even greater impact on this age category.

The structural trend that is shifting the structure of employment from low-skilled jobs towards higher-skilled ones is expanding divergences between countries, particularly through the recent incapacity of southern countries to develop more highly skilled jobs.

Correlation between countries has been greatest in women's jobs, driven by political and cultural will, at least until 2019 but divergences are still wide and worsened considerably in 2020.

Will the Next Generation EU recovery plan be enough to reconverge countries?

1/ Comparative analysis of Eurozone employment in the entire population, among young people, and between genders

Employment developed more favourably among women than men from 2006 à 2020.

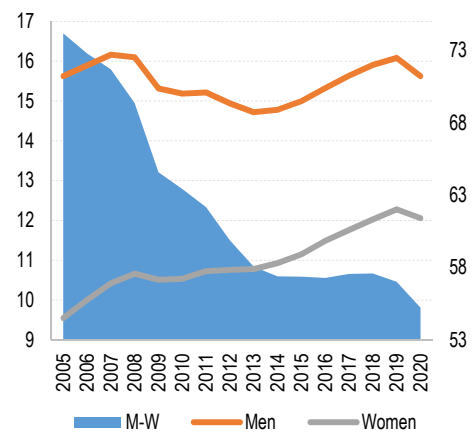
Only from 2015 to 2017, when job numbers surged, did the trend favour men slightly. Over the entire period, the employment rate among women converged towards the rate among men (by 7 points, or 13%).

The employment rate among women nonetheless varies widely from one country to another – from 50 (the lowest) in Italy to 75 in Germany (the highest). The rate among men is more homogeneous from one country to another, ranging from 60 to 80.

Variability[4] between countries widened from 2006 to 2020, less so for women than for men. The impact of the 2008 crisis caused growing divergences until 2013, which were then offset partially by job market growth until 2019. A new divergence shock between countries then occurred, particularly among women, as lockdowns caused many of them to pull out of the job market, particularly for family reasons and particularly in southern European countries, which are relatively underserved by day-care facilities.

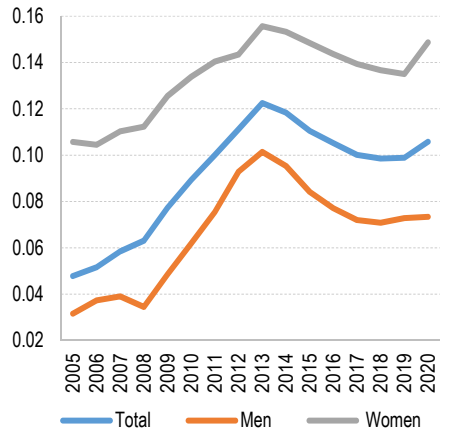
The average trend described above covers trends that differ vastly from one country to the next. While the employment rate rose among men in Germany from 2006 to 2020 (by +9%), it stagnated in France and fell in Italy and Spain (by -4.6% and -13%,

1/ **Employment rate**



Source: Eurostat, Amundi Research - Data as of 02/06/2021

2/ **Sigma-convergences employment rates in the four countries**



Source: Eurostat, Amundi Research - Data as of 02/06/2021

THEMATIC

Youth employment receded everywhere

respectively), while the employment rate among women rose across the board from 2006 to 2020, but to varying degrees (e.g., from +19% in Germany to +3.5% in Spain).

2/ Comparative analysis of employment in the Eurozone and the United Kingdom among young people and in relative terms among young women and young men

Employment rates among young people diverged widely from 2010 to 2019. While the rate rose in Germany (and in the UK) to close to 50% in 2019, it fell in the three other countries, to close to 20% in southern countries and 30% in France. Employment rates were higher in the UK than in Germany. The Covid-19 crisis widened divergences considerably in 2020: **youth employment receded everywhere** but in a highly staggered fashion from one country to another. **The decline ranged from very low in Germany to considerable in Spain (-17%).**

Gaps from one country to another are even greater in employment of women. The two employment rates are closest in the UK , at about 50%, as well as in Germany; they are the lowest, and the furthest apart in Italy (21 for men and 15 for women in 2019). The Covid-19 shock has been very great to women's employment in Spain and Italy (about 15%), and it has exacerbated the divergences.

3/ Analysis of Eurozone job market by qualification

Historically, there have been more low-skilled jobs than high-skilled ones in the Eurozone[5]. These two categories of jobs have tended to converge through greater creations of high-skilled jobs than of low-skilled ones.

The breakdown between the two categories of jobs is different between northern Europe, which has more high-skilled jobs, and southern Europe , which has more low-skilled ones.

The proportion of higher-skilled jobs has stagnated in southern countries while Germany has a higher number of workers in manufacturing than France, and its number of blue-collar jobs has declined less.

There is therefore a widening divergence between Eurozone countries in this breakdown[6].

This divergence occurred more during the post-2008 recovery than during the 2008 crisis, but accelerated with the Covid crisis.

The Covid crisis had an impact similar to that of the 2008 crisis, but to a far greater extent (-5.93% in lower-skilled jobs in one year and -0.26% in higher-skilled jobs), which accentuated the trend and the divergences among countries. In absolute terms, lower-skilled employment has not been this low since 2008, while higher-skilled jobs are close to their highs.

Italy stands out from other countries and, generally speaking, divergences widened between the northen and southern countries in 2020.

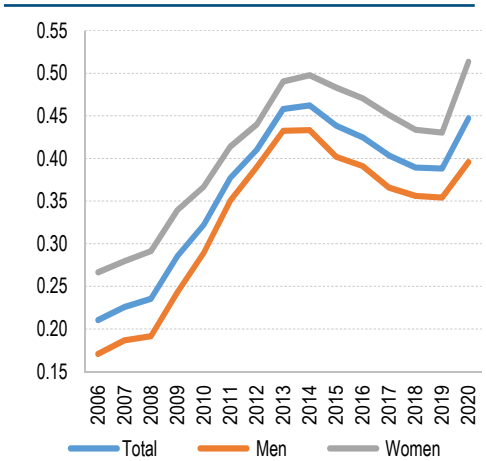
Conclusion

The Next Generation European Union (NGEU) plan serves as a relay to the SURE fund, which supports short-time unemployment benefits. NGEU's goal is to assist Eurozone countries in proportion to their respective needs, in supporting the recovery and the changes that will help promote that recovery.

That being said, it is the responsibility of each country to organise the implementation of the aforementioned mechanisms, including job recovery, assistance for better integration of young people and women on the job market, restructuring, financing, and related legal and administrative procedures, training, digital and environmental changes, and so on.

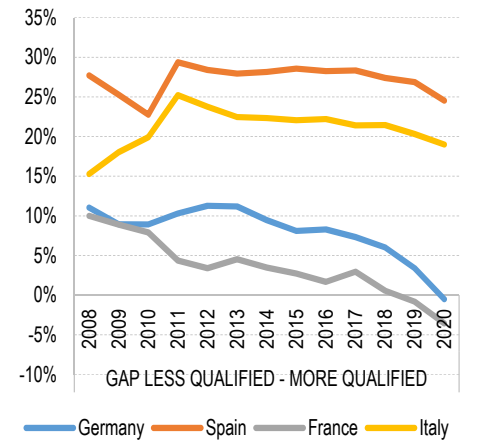
The 7-8 May 2021 Porto social summit addressed this quite directly and in a highly ambitious manner. It aims to raise the percentage of working 20- to 64-year olds to 78% and the number of adults undergoing annual training to 60% by 2030.

3/ **employment rate in the four countries**



Source: Eurostat, Amundi Research - Data as of 02/06/2021

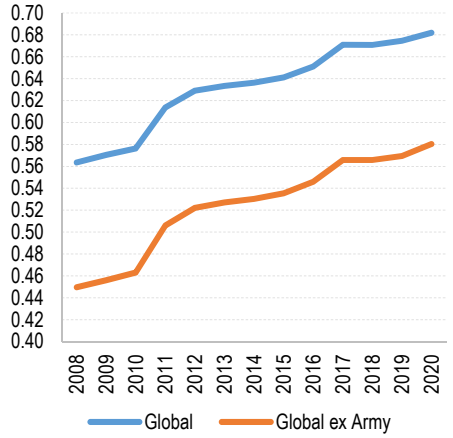
4/ **Less-skilled/more-skilled gap**



Source: Eurostat - Amundi Research - Data as of 13/04/2021

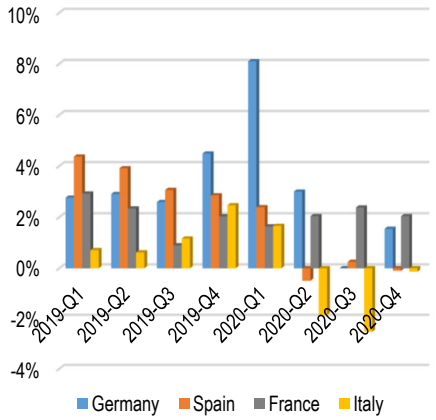
THEMATIC

5/ **Divergence in job skills between countries**



Source: Eurostat - Amundi Research - Data as of 13/04/2021

6/ **QoQ change in percentage of higher-skilled jobs**



Source: Eurostat, Amundi Research- Data as of 13/04/2021

But as the fiscal rules of the Stability and Growth Pact will soon return to the spotlight in the Eurozone, governments and central banks will probably be paying more attention than in the past to actual economic fragmentation. In the United States, as in the Eurozone, central banks are focusing increasingly on the job market. The ECB is focusing in particular on the convergence of national job markets, as this will play a role in medium-term price stability.

Finalised on 25/06/2021

[1] *Unless otherwise stated, the Eurozone is assessed through its four largest countries.*

[2] *15- to 64-year-olds.*

[3] *15- to 24-year-olds.*

[4] *Convergence is assessed through the notion of sigma-convergence (see Eurofound research report on "Upward convergence in the EU: Concepts, measurements and indicators), which reflects a reduction (or increase) in disparities in statistical observations between countries over time. It reflects the notion of homogeneity among countries. Sigma-convergence is invariable in terms of scale and therefore helps compare the variability of various indicators (Kenworthy, 1999). CVt= sigma t/ut - Sigma t = variance of the series in t - Ut = average of the series in t - If CVt falls over time (t), there is a convergence in figures; if it rises, there is a divergence. Data are from Eurostat.*

[5] *Jobs considered more higher-skilled: executives, professionals, technicians and related professionals, skilled farm workers; jobs considered lower-skilled: office workers, craftsmen and workers in related fields, operators of installations and machinery and assemblers.*

[6] *Chart 5 covering eight historic countries accounting for 90% of GDP of the Eurozone population: Belgium, Germany, Spain, France, Italy, Netherlands, Austria, and Sweden and providing sigma-convergences (standard deviation from the mean).*

CENTRAL & ALTERNATIVE SCENARIOS (12 TO 18 MONTHS HORIZON)

Monthly update

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

DOWNSIDE SCENARIO 25%

Slumpflation

Analysis

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

Market implications

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

CENTRAL SCENARIO 60%

Multi-speed recovery

Analysis

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

Market implications

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

UPSIDE SCENARIO 15%

Sustainable & inclusive recovery

Analysis

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

Market implications

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

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

TOP RISKS

Monthly update

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

ECONOMIC RISK 20%

- **4th wave of Covid-19**
  - Despite mass vaccinations, a new wave kicks in after the summer holiday in the northern hemisphere
  - New lockdowns and restrictions derail the recovery
- **Pandemic 2.0**
  - One or several virus variants that would make existing vaccines ineffective OR
  - unexpected logistics issues or side-effects of the vaccines could undermine the economic recovery
- **Global tapering**
  - As inflation expectations rise, the Fed and other DM central banks could reduce their asset purchase programs earlier than expected and stop or slow the recovery
  - Central banks' reaction function, premature exit or miscommunication could be sources of uncertainty
- **A protracted recovery with multiple relapses** might hit business and consumer confidence, looping in sectors that have not yet been directly hit by the pandemic, such as financials

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

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

FINANCIAL RISK 20%

- **De-anchoring inflation expectations** leading to a bond market dislocation as an outcome of policy mistakes, such as pre-emptive monetary policy tightening or outsized fiscal plans
- **Corporate solvency risk:** despite improving fundamentals, the magnitude of the recession could increase solvency risks once central bank liquidity and government guarantee schemes are withdrawn
- **Sovereign debt crisis**
  - With public debt as a share of GDP reaching historically high levels in peacetime, most countries are vulnerable to rating downgrades and rising interest rates, 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 20%

- **US & Europe vs. China cold peace**
  - US takes a hard line with China
  - Sanctions, disclosures requirements and delistings of Chinese companies are signs of escalation
  - European countries could follow the US, despite their economic interests
  - Lost influence of the US post Afghanistan exit
  - Possible accidental confrontations in the South China Sea or the Taiwan Strait
- **European populist vote** in Germany, France or Italy could lead to a further fragmentation of the EU
- **EM political instability driven by:**
  - Chaotic virus crisis management and public debt level
  - Higher food prices leading to a wave of unrest in EM similar to the Arab Spring
- **Cyber-attack or data compromise,** disrupting IT systems (security, energy and health services)
- **Underestimated hysteresis effects in DM labour markets,** with rising unemployment, which could generate social tensions

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

- Oil, risky assets, EMBI

Covid-19 situation update

Pierre BLANCHET, *Head of Investment Intelligence*

As of the end of August, nearly 40% of the world population had received at least one dose of vaccine. The US has reached 60% and most European countries are at or above 70%. The pace of vaccinations has accelerated over the summer globally, and 40 million doses are being administered each day. A third, "booster" jab is starting to be given to vulnerable people. Highly populated countries such as China (1 billion doses) and India (500 million doses) have made huge efforts to protect their people against the disease. However, fewer than 2% of people in low-income countries have received at least one dose. Several large countries, such as Russia, where only 25% of the population are fully vaccinated, are struggling to get closer to herd immunity. As the Delta variant continues to spread across the globe, new mobility restrictions and lockdowns have been implemented in several countries. Vaccines have been proven effective to protect against serious illness but do not block virus transmission. Israel, for instance, has seen a surge of new cases despite one of the highest vaccination rates. The pandemic will therefore remain a source of economic and political uncertainty for the near future.

CROSS ASSET DISPATCH: Detecting markets turning points

Monthly update: The trafic light has turned red on fundamentals and valuations

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

ECONOMIC BACKDROP

- Economic activity expanded at a solid rate over the summer, benefiting from the easing of Covid-19 restrictions. The positive momentum is expected to continue in the third quarter, with growth rates heading toward a progressive stabilisation, as confirmed by the ongoing flattening of high frequency indicators and soft data.
- Economic activity in the US continues to grow at a sustained rate. However, signs of an ongoing deceleration in growth rates arose, confirmed also by the flattening high frequency indicators and the moderating soft data. The CESI Index turned into negative territory, affected by weaker soft and hard data surprises, while the consensus continues to progressively moderate, remaining in positive territory.

FUNDAMENTALS & VALUATION

- Most equities have reached all-time highs while the recovery in profits has started slowing. Valuations look expensive from different angles, and markets are vulnerable to corrections
- CB liquidity injection is still the only argument for the markets' high levels, although upside is very limited as of today.
- Absolute PE levels are above historical trends and are a sign of investor complacency.

NEUTRAL + ASSET ALLOCATION

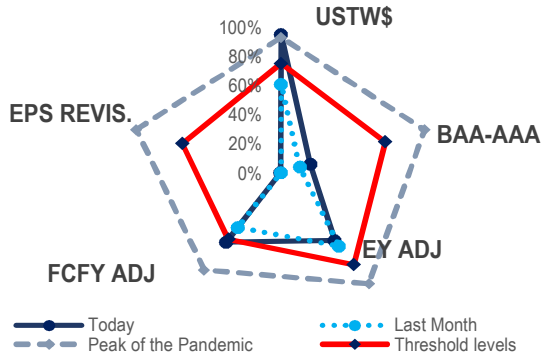
TECHNICALS

- There were no big shifts in contributions with respect to last month from our technical toolbox.
- Risky assets kept delivering performance during the summer, but volatility spikes have resulted in unstable trends, above all in global equities.
- RSIs are showing a similar picture. Given the strong YTD performance, RSIs in global stocks are getting stretched. On the other hand, they seem as expensive as most assets, resulting in not clear-cut relative intuitions.
- Technicals remain mixed with a lack of directional bias at the time of writing.

SENTIMENT

- We are still lacking evidences of material deterioration in systemic risk sentiment in our framework.
- Volatility rose ahead of Jackson Hole, but most of our metrics remained pretty much resilient.
- Financial conditions deteriorated modestly, with GEM FCI deteriorating sharply with respect to DM ones. This is definitely linked (on top of China) to the rebound in the USD, which is the only variable calling for a risk-off in our CAST model. Whilst disappointing, growth figures started (marginally) translating into less positive EPS revisions, analysts' sentiment remains high and credit risk premium stays solid (well below our alert threshold, as we speak).
- Institutional investors' risk appetite stayed neutral during summer, with timid signs of renewed appetite towards risky assets at the end of August.

Cross Asset Sentinels Thresholds (CAST) still supportive



Source: Amundi Research, Data as of 2 September 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: solid but declining growth momentum

- Inflation keeps rising, corroborating our convictions of a stagflationary second derivative scenario, under which growth level remains above average but the rate of change decelerates amid a series of CPI hot prints.
- Fed Chair Powell confirmed with little detail the gradual shift of monetary policy – splitting the rate hike from tapering.
- A tapering announcement at the Sept 21-22 meeting could be a source of market volatility.
- We do not expect tapering to be a major game changer, but with the end of the carry supportive period, we should see rates move up going into the Q3.

US Treasuries: We have revised our yield targets on the downside

- We expect the Fed to remain on the dovish side because of these global growth concerns.
- US treasuries' long end have endured years of unconventional monetary policy.
- During the pandemic the Fed balance sheet expanded from $4 trillion to $8 trillion, weighing on the long end of the curve; it will take time for the market to revert.
- Tapering will be smooth and the rise in long term bond yields will be contained.
- Rates hikes would have a limited impact on the 10y UST.

Investment consequences:

- We now expect the 10y UST yield to reach 1.4 to 1.6% by yearend and 1.6 to 1.8% within 12 months.
- Keep short UST duration positioning.

2 Eurozone: better than expected economic outcome

- Growth in the periphery drifted higher, leading to higher growth expectations for the EZ.
- ECB firepower remains powerful, in accordance with the "lower for longer" theme. The upcoming ECB meeting, Fed tapering, and German elections will be key volatility events.
- EZ core rates appear rich in both absolute and relative terms vs the periphery and the credit market. A range-bound regime looks likely to persist for Bunds and non-core.

Investment consequences:

- Short core - limited upward lift on German Bund with inflation peaking in autumn.
- Long EZ periphery bonds (Italy).

3 German elections: the most open political race in a generation

- Scholz is more popular than other candidates and has revived the SPD's voting base.
- Neither the SPD nor the CDU will have enough votes to build a two-party coalition.
- An SPD+FDP+Green coalition is now a possibility. The Greens & SPD could push for more fiscal spending and more risk burden sharing in Europe.

Investment consequences:

- We expect elections to be a key volatility event, but the outcome and the market impact is too early to predict.

4 China: slowdown in Q3 and then moderate rebound in Q4

- We now expect a sequential slowdown again in Q3, on renewed lockdowns and previous policy tightening and then a moderate rebound in Q4 (at a pace similar to Q2 this year).
- The PBoC's broad policy tapering plus sector-level tightening was the major culprit behind the slowdown.
- New social distancing rules since late July and Delta variant-related issues will become more visible in the August consumption data. China's policy stance will turn more decisively to the dovish side.
- We expect policy loosening to come from the credit and fiscal sides, while the PBoC sticks to an accommodative liquidity stance without rate cuts.

Investment consequences:

- Selective exposure to Chinese equities: seeking opportunities on regulation-insulated sectors (e.g., clean energy and bio tech).
- Positive on Chinese bonds (HY and hard currency).

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CROSS ASSET INVESTMENT STRATEGY

September 2021 #09

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