



Research

#03  
March  
2021

# CROSS ASSET

## Investment Strategy

CIO VIEWS

How hot is the inflation pot?

THIS MONTH'S TOPIC

China and EM: growth and policy Q&A

Confidence  
must be earned

**Amundi**  
ASSET MANAGEMENT

## #03 - March 2021

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The return of inflation narrative is gaining traction, propelled by the expected large US fiscal package and demand recovery that should come as the vaccination campaign progresses. Investors should continue to prefer equities over bonds, keeping a tilt towards more cyclical markets, but stock selection remains important. On the other hand, investors should aim to protect portfolios from inflation, through breakevens, and test each investment case against a possible rise in prices. Finally, a risk-on approach in credit markets is appropriate to benefit from CBs' umbrella and from the increasing tilt towards green and social bonds.

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Given the context, Q4 2020 corporate earnings proved resilient. The regions least impacted by the pandemic, such as EM (+25%) and Japan (+20%), experienced notable increases. In the rest of the world, where the pandemic was more virulent, the US still managed to post a positive gain (+4%) while Europe was more affected (-20%). However, even in the most affected regions, the results were far better than expected, with the most significant progress coming from cyclical sectors.

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While the spectacular Covid shock may easily lead to exaggerate extrapolations, it cannot be ruled out that it will matter for long-term productivity and growth. However, the effects could work both ways. Reasons why the current crisis could further worsen "secular stagnation" are many, yet there are also a channels through which it could work positively.

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## CIO VIEWS



**Pascal BLANQUÉ,**  
Group Chief Investment Officer



**Vincent MORTIER,**  
Deputy Group Chief Investment Officer

## How hot is the inflation pot?

If the start of 2021 led markets to question the *no inflation forever* mantra, the debate has been hotting up in February, with the US 10Y inflation breakeven reaching its highest level since 2014, pricing in higher inflation expectations. We are also seeing pricing pressure on the food and energy side. Despite this rising trend, absolute inflation levels remain subdued. Some inflationary pressure is more than expected this year on base effects. However, the problem is not this short-term rebound of inflation, but the change in the paradigm ahead. **The hot questions today are how much inflation surprise can we envisage for 2021 and how temporary will this inflation pick-up be?** Or are we heading towards a prolonged period of higher inflation? The return of inflation narrative is gaining traction, propelled by the expected large US fiscal package and the recovery in demand that should come as the vaccination campaign progresses. The proposed package of \$1.9tn has led some economists (Summers, Blanchard) to warn that inflation will be the end game of this huge fiscal push. However, others argue that there is room for this package, as the job market is still weak and it should not lead to a permanent rise in inflation as wage growth should remain limited.

**Importantly, the starting point out of this recession is very different from that of 2008.** First, this is a huge temporary shock that will be followed by a sharp reversal with less permanent consequences than a financial crisis. Second, the high levels of liquidity in the system, higher personal income and savings and the strong wealth effect will likely unleash pent-up demand: a cocktail that could further fuel inflation. Third, there is a risk that CBs will be trapped in their mantra of low interest rates and accommodative policies to restore economic conditions and tackle strategic social themes.

The big fiscal stimulus could make the case for a strong economic rebound which could not only drive some inflation pressure **but also further increase divergences between the US and the rest of the DM world.** This will make the case for being short the dollar quite challenging and increase the appeal of US fixed income in the desert of yield. **China (and more broadly Asia) is maintaining a solid recovery pace** and this was reflected in buoyant equity markets at the start of the year. The Asian region continues to be attractive to investors: it remained very resilient last year in terms of foreign direct investments (FDI) in an overall weak environment, and China for the first time surpassed the US in FDI flows. Signs of deceleration are emerging here as well, but if we look at the change in PMI over the last three months, China and India are among the best performers, together with the US. India's new pro-growth budget is likely to see investors return to the country. Against this backdrop, our key convictions are:

- **As the deflation trade continues, investors should still prefer equities to bonds, keeping a tilt towards more cyclical markets** (Japan and EM Asia) and start to build in some laggards/value markets (Russia). But, investors should monitor the impact of inflation on earnings through input prices, which is emerging as a topic for discussion. As there is a rising consensus on cyclical trade with the reopening of the economy, selection in equities is increasingly relevant. The focus should be on sound businesses with a preference for value vs. growth as a multi-year rebalancing trend. In the short term, any sign of deceleration in economic activity may pause the rotation, but we believe this will be temporary and further reinforced by a steepening of the yield curve and an interest rate rebound.
- **Stay risk-on in credit markets to benefit from central banks' umbrellas**, and start to increase the tilt towards SRI in bonds (green and social), as CBs may start to adjust their purchasing programmes in this direction. For example, in Europe, the ECB's Villeroy has recently proposed starting to decarbonise the ECB's balance sheet, while President Lagarde also made clear the ECB's willingness to take steps towards taking a more active role in fighting climate change. This is just the beginning of a trend that we think will continue as CBs' mandates start to adapt to the new post-Covid paradigm (huge fiscal push to fight the pandemic and move towards a more green economy and inclusive growth model).
- **Start building hedges against inflation risk with breakeven** and more generally with an investment approach that tests each investment case against a possible rise in inflation. This will affect sector allocation with a preference for sectors linked to real assets (commodities, energy, infrastructure) and single name selection with a preference for businesses with manageable debt levels, realistic valuations and pricing power.

## Overall risk sentiment



Risk-on attitude, with equity favoured to credit in a reflationary environment. 10 year US rates above 1.5% are a key risk to monitor

## Changes vs. previous month

- ▶ Upgrade of selective cyclical/commodity FX
- ▶ More constructive on US breakeven, cautious on UST in global fixed income
- ▶ More cautious on EM local currencies

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

## MACRO

## Inflation risk amid labour market slack and “act big”



**Monica DEFEND,**  
Global Head of Research

*Improving growth prospects and a high fiscal package in the US may cause a higher inflation trend but labour market slack would prevent excessive inflation at least in 2021*

- **The inflation narrative is back in focus. We reiterate our preference for value, cyclicals, EM assets and US breakevens.**
- **Labour markets slack would temper inflation dynamics this year, notwithstanding the size of the US fiscal package and Yellen’s “act big” moment.**
- **We expect a more uncertain environment for the US dollar.**

We believe a more successful vaccine rollout and expectations of a sizeable US fiscal package favour US growth over Europe. Amid this background, a fascinating debate on inflation is occurring. Our Global Inflation Focus index flags this narrative of a rising inflation trend, particularly in the US.

**Where do we stand on this inflation debate?**

- **Labour market** – We expect the CPI to move higher, then stabilise and not accelerate further. An important factor here is the labour market, which we do not see recovering to its pre-crisis levels, not even in 2022. There are divergences, in terms of unemployment in different sectors and a skill gap, which has aggravated inequalities. A labour market recovery will be uneven and take some time, thereby damping down inflation pressures at least in 2021.
- **Output gap** – We estimate the US output gap to be worth \$900bn and we put that into the context of the labour market data. **The size and in particular the destination of the fiscal package in 2022/2023 might trigger a structural change in the US** in terms of productivity and labour market dynamism.

We expect breakevens to move higher on the back of fiscal impulses and improving growth.

**Separately, the 5/30Ys real rate curves may steepen further.** The 5Ys should drift lower on the Fed’s stance of keeping rates low and tolerate higher inflation while the

long end will price in the additional fiscal stimulus and a faster recovery.

While we think there’s an upper limit to the long end of the curve (10Y Treasury yield at 1.50% remains pivotal to us), some more inflation may be tolerated by the Fed as the debt will eventually become more serviceable (and counter-balance a moderate and smooth rates increase).

For this reason, we believe investors should remain cautious on US duration and constructive on US breakevens.

On the other hand, **slightly higher inflation-tolerance by the Fed, which is not expected to be pre-emptive in hiking rates, is likely to cheer equity markets.** We are comfortable with cyclical, value and EM (full spectrum). Obviously, the management of the Covid-19 crisis and avoiding the emergence of any new virus strain will be important, given that the market is not considering any further healthcare-related issue (this is a key risk).

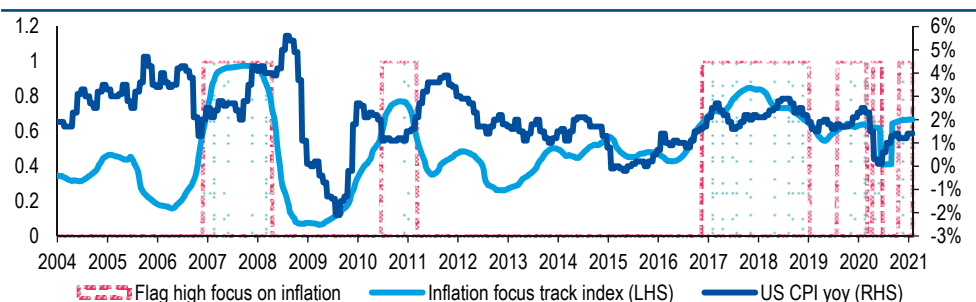
In addition, the **hedging characteristics of equities during regime shifts support this asset class.** According to our analysis, equities should offer a good hedge against an inflation regime shift based on higher growth, improving corporate fundamentals, and higher unit labour cost, which can be passed on to consumers.

**The one caveat.** As per our analysis on monthly returns since 2000, rising breakeven and falling real rates have historically triggered a USD sell-off. For the time being, we see the USD remaining weak vs. commodity FX and strong against low yielders (namely the CHF, the yen).

However, in H2, this trend may pause, with the environment becoming more mixed for the USD. When breakevens reach the tipping point and fall (and real rates rise), we might see the USD get stronger.

We are not there yet, but we believe this would be a key risk to monitor.

### Inflation Focus Track Index



Source: Amundi Cross Asset Research, as on 7 February 2021. Methodology: Inflation Focus Track Index is Amundi’s Cross-Asset Research proprietary tool based on big data analysis from the web (Google Trends). The relevant text/word combinations for the inflation theme are identified and dynamically tracked according to the popularity of web searches. We detected two relevant regimes (high focus and low focus) to articulate the most appropriate cross-asset investment implications.

## MULTI-ASSET

## Benefit from reflation and relative value strategies



**Matteo GERMANO,**  
Head of Multi-Asset

*In an overall supportive environment for risk assets, with some indicators softening, we see selective opportunities in the FX markets to play long-term green themes and a pro-cyclical tilt*

An improving economic backdrop in both DM and EM on the back of a stimulative economic policy mix is reflected in business confidence, the market's inflation expectations, and UST yields. While manufacturing continues to display resilience, services are showing signs of divergence amid Covid-19 restrictions and variants. Divergences are also emerging at regional levels (ie, the US and the EU). This environment confirms the dependence of economies on successful vaccination and where absolute and relative valuations are showing a dichotomy. **Investors should keep an active stance in search of opportunities across and within asset classes**, but acknowledge some noise and volatility in rates and inflation trends. Accordingly, adjustments are required to dynamically adopt the overall stance.

#### High conviction ideas

A rebound in manufacturing, earnings revisions and easing financial conditions allow us to **maintain our positive view on equities, even as we acknowledge that some pockets are stretched, underpinning our selective and relative value approach**. We remain neutral on Europe and the US, and constructive on Japan and Australia as the last two should find support in their pro-cyclical tilts. On EM, **we maintain our optimistic view on Asia** through Chinese 'old economy' stocks and consumer discretionary names. Investors can play the laggards/value story through South Korea, Latin America and Russia.

**On duration**, we keep a neutral view on the US (UST10Y) for diversification purposes and we favour breakevens. In the UK, we believe investors should now consider curve steepening strategies, particularly along the 2-10Y side. The Bank of England's (BoE) dovish stance and the rising gilt supply towards the long end of the curve may put upward pressure on long-term yields. In addition, the country's success on the vaccination front and rising consumer prices support higher inflation expectations. In Europe, even though the

current valuations of peripheral debt offer lower potential for further tightening, we remain constructive. This is particularly true for a relative value strategy of 30Y Italy vs Germany on the back of the ECB's firepower, demand from foreign investors for Italian debt, and the new government lead by former ECB president Draghi.

**Credit** continues to be supported by quantitative easing. We expect very limited spread tightening, but the asset class still provides some yield. We favour EUR IG given its lower leverage vs US IG.

On EM FI, we remain positive, but now recommend investors fully hedge US rates (USD and duration) exposure to smoothe the risks of higher growth/inflation dynamics, which are being supported by stronger fiscal stimulus in US. We also believe there is higher potential for spread tightening in HY compared with IG. Even regarding local rates, where the main driver remains FX exposure, room for further compression is limited.

In currencies, a pro-reflationary environment, coupled with the relative value opportunities in this space, enables us to **upgrade our view on the GBP and CAD** vs the CHF owing to attractive valuations. We maintain our views on the CAD/USD and NOK/EUR. In EM, while we maintain our positive stance towards an EM FX basket, we upgraded the RUB. Separately, we also improved our views on the CNY and KRW vs the EUR, driven by expectations of inflows into CNY assets and by the possibility of participating in the global transition towards the green electrical energy world, which relies on conductive metals, such as semiconductors.

#### Risks and hedging

Any material increase in rates and inflation dynamics and UST yields could affect the appeal of equities vs bonds, as the cost of funding would increase. As a result, we stay vigilant and recommend investors protect equities, credit and duration exposures through multiple hedging strategies. Gold could also provide support amid abundant liquidity in the current environment.

#### Amundi Cross Asset Convictions

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

Source: Amundi. The table represents a cross-asset assessment on a 3- to 6-month horizon based on views expressed at the most recent global investment committee. The outlook, changes in outlook and opinions on the asset class assessment reflect the expected direction (+/-) and the strength of the conviction (+/++/+++). This assessment is subject to change. UST = US Treasury, DM = Developed markets, EM/GEM = Emerging markets, FX = Foreign exchange, FI = Fixed income, IG = Investment grade, HY = High yield, CBs = central banks, BTP = Italian government bonds, EMBI = EM Bonds Index.

## FIXED INCOME

## Progressive discrimination in a risk-on environment



Éric BRARD,  
Head of Fixed Income



Yerlan SYZDYKOV,  
Global Head of Emerging Markets



Kenneth J. TAUBES,  
CIO of US Investment  
Management

*In an environment of state support for markets, investors should explore sectors and names where there is visibility and transparency on future cash flows*

We believe the development of herd immunity and expectations of continued fiscal stimulus will drive an economic rebound. However, questions such as those related to the pace of this recovery, inflation, extension of the pandemic, and credit quality remain unanswered. We may now see already expensive assets increasing in value as CB-infused liquidity and investors' search for yield boost prices for some pockets in the credit market. On the other hand, cheaper and low-quality assets may fall even more. As a result, **investors should complement their risk-on stance with a prudent, selective and research-driven approach in credit.**

## Global and European fixed income

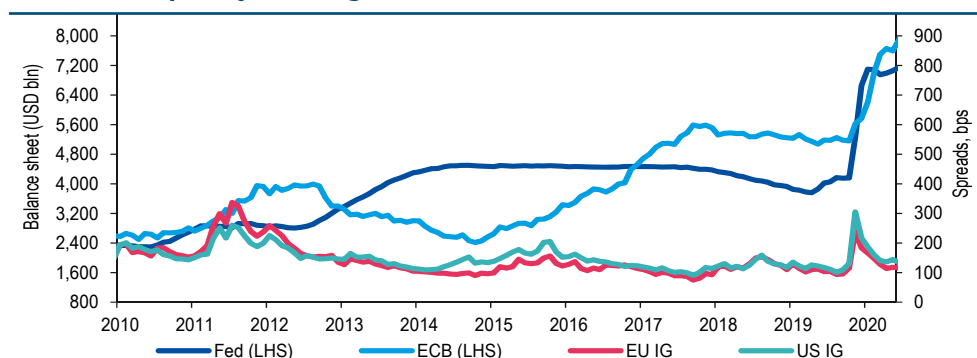
**We downgraded our view to become cautious on US duration** amid huge fiscal support and inflation, while staying defensive overall, including in Europe. We believe the US curve is likely to steepen and, as a result, investors should maintain a barbell exposure along the 2-10Y and 30-10Y curves. **On breakevens, we upgraded our view on US 10Y and 30Y** (the Fed's tolerance for higher inflation, structural changes, base effects) and moved to a neutral/positive stance on Europe.

Regarding Europe, we remain positive on peripheral debt, particularly on Italy, but see growth concerns. The new government has reduced political risks for now, but we remain vigilant.

We remain positive on credit, as rising inflation expectations affect real yields, but **prefer shorter-dated debt in general.**

Some spread tightening is more likely in HY, particularly in lower-rated and hybrid instruments, which could offer opportunities too. Euro financial subordinated debt is another area we like, provided they become eligible for ECB bond buying.

## CB-driven liquidity is lifting all boats



Source: Amundi, Bloomberg. Latest monthly data as at 17 February 2021.

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, JGBs = Japanese government bonds, EZ = Eurozone, BoP = Balance of Payments.

## US fixed income

Fiscal profligacy, and additional spending by the private sector, coupled with a supportive Fed (which is keeping rates low and financial conditions easy), point to an economic recovery. Add to this the difficulty in finding skilled labour and excess household savings and you get rising inflation expectations and a steeper yield curve. **This explains our negative stance on USTs and positive view on TIPS.** But, twin deficits and fiscal deterioration are not a good recipe for a strong USD in the medium term (although investors should watch out for rising rates).

Risky assets — corporate credit, securitised credit and housing markets — are a key component for generating returns. **However, a high level of selectivity is crucial across the board, with a strong focus on corporate fundamentals.**

Securitized credit, especially related to the housing market, is displaying robust fundamentals and technicals. Finally, the mortgage market remains supported by consumer earnings and savings.

## EM bonds

Developments around Covid-19 are pressurising growth expectations, but the EM/DM growth differential is still expected to increase. We maintain our positive stance on HC, especially in HY. **On LC and FX, we are more cautious now** in light of the upward pressure on US rates and the USD's direction, but believe certain EM currencies will continue to perform. At a country level, Russia and Brazil are two of our main convictions.

## FX

We are now neutral on the USD vs JPY and CNY amid better US growth prospects and upward movement in US rates. We are also positive on commodity FX vs the EUR and the CHF.

## EQUITY

## Play reflation through value, cyclical and small caps



**Kasper ELMGREEN,**  
Head of Equities



**Yerlan SYZDYKOV,**  
Global Head of Emerging Markets



**Kenneth J. TAUBES,**  
CIO of US Investment  
Management

*Higher rates and market exuberance in some sectors are conditions that make us even more focus on valuations and fundamentals*

## Overall assessment

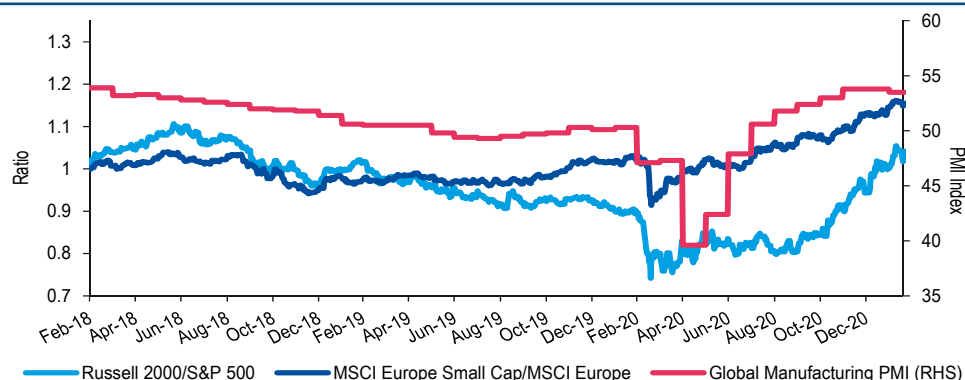
Markets are looking beyond the near-term headwinds of Covid-19 and a sluggish vaccine rollout across Europe. Sentiment appears to be driven by hopes of continued policy support combined with an increasingly clear path to reopening. However, the actual situation is more nuanced, as this positive sentiment has turned **into exuberance in some segments**, leading to the possibility of high volatility, especially in interest-rate-sensitive sectors. We believe in imposing some cautious optimism onto this exuberance. **Investors should rely on fundamental analysis and process discipline** to unearth businesses with sustainable income streams/balance sheets.

## European equities

**We continue to believe in the story of cyclicals vs defensives and value vs growth**, but it is important to acknowledge that some segments have already discounted a very rosy opening, which underpins the need for a selective approach.

In particular, we like banks, as this is an area where reopening is not yet discounted; we also maintain our bias towards materials and healthcare. On the other end, we downgraded interest-rate-sensitive sectors such as real estate and are cautious on capital goods, as the sector has been very fast in pricing in a recovery. We are negative on segments such as technology which display prices that are way above fundamentals. However, we see inflation and market consensus on recovery as key risks. Thus, we maintain positions in some defensive components of the economy such as telecommunications, which we have upgraded. Finally, we like small caps as they are reasonably priced and are linked with the cyclical domestic recovery theme. All in all, we remain valuation-conscious.

## Cyclical recovery should support small caps



Source: Amundi, Bloomberg, latest data as on 18 February 2021.

## US equities

Substantial fiscal stimulus, progress on the vaccination front, and strong corporate earnings make economic rebound, profit recovery and reflation the main themes in the near term. This thinking supports our expectation of a sustained leadership rotation out of high growth/momentum and high duration stocks, which are more dependent on discount rates for their high stock prices. Low rates have driven their cost of capital lower and valuation multiples higher, which is a key risk. But now, with steeper yield curves and inflation expectations, their prices may be affected. **Instead, value (high-quality value) and cyclical stocks should gain due to their attractive valuations and improving cyclical earnings later in 2021.** We are also constructive on cyclical sectors as they gradually price in the economic recovery. From a sector perspective, a steeper yield curve should support financials and energy over industrials (high earnings multiples) and this marks a switch from 2020, when yields were very low. Importantly, investors should explore sectors where recovery is not yet priced-in by the market. Overall, we remain very selective and believe there are opportunities in Covid-impaired sectors, but new virus strains could present some risks.

## EM equities

Difficulties in vaccine production and spread of Covid-19 variants affected some EM but this doesn't alter our long-term constructive view on the region, where selectivity is important. We maintain our positive stance on discretionary, IT and real estate. While we remain cautious on staples, we upgraded the sector marginally through bottom-up ideas in China. However, we are concerned on some Chinese financial names due to high valuations as we continue to look for value stocks with cyclical, growth and quality characteristics.

## THEMATIC



**Didier BOROWSKI,**  
Head of Global Views



**Pierre BLANCHET,**  
Head of Investment Intelligence

*An inflationary mini-boom will also boost corporate profits*

*Signs of a bubble can be witnessed in many aspects of the equity market*

## All bubbles are not equal

Predicting the growth and bursting of bubbles is a difficult task, even considered as impossible by some. In fact, bubbles can last for a long time and are only apparent when they burst. Calling them too early can lead to suboptimal allocation. However, there are signs of market exuberance, particularly in the tech sector. These high valuations are driven by high growth expectations and, more importantly, ultra-low discount rates, the normalisation of which could trigger a bursting of the bubble. Although a major source of risk for investors, history shows that all bubbles are not equal when it comes to their impact on the economy.

Cycles in financial market segments (equity, housing or credit) are playing an important role in shaping recessions and recoveries. The current recovery has hardly started, and **growth might surprise on the upside in the short term.** In the US, President Biden's \$1.9 trillion (9% of GDP) fiscal stimulus plan raises concerns of overheating in the second half of 2021. Chinese GDP might grow as much as 9% this year. Europe, for its part, is expected to benefit from two consecutive years of strong growth. Inflation is expected to rise too, in particular in the US. Although it would be short-lived in our view, an inflationary mini-boom would also boost corporate earnings expectations and investor confidence. **The strong momentum on the equity markets might therefore continue for some time, supported by strong nominal growth.**

The most striking feature of this new cycle is the level of indebtedness. Private and public debt post- Covid-19 have surpassed the historical highs reached at the end of WWII. Higher nominal GDP growth might support debtors but at the same time should lead to higher long-term interest rates. It might also put central banks, and the Federal Reserve in particular, under pressure to withdraw their accommodative programmes. However, as we argued in last month's paper (*Taper or not taper*), the Fed is unlikely to stabilise its balance sheet and raise policy rates until the economy is well on track: returning to full employment will take much longer than returning to pre-crisis GDP levels. The slack in the job market should prevent wages from soaring (the Phillips curve has flattened) and, in any case, the Fed has adopted for a new strategy (average inflation targeting) that allows it to wait and see if inflation surprises on the upside.

Finally, **maintaining bond yields well below nominal potential GDP growth is a prerequisite for public debt sustainability.** Therefore, a potential outcome of this unusual recovery, in which CB balance

sheets will continue to grow even as growth accelerates, is an asset price bubble, starting with **assets whose valuations are highly sensitive to distant future profits.**

### Signs of bubbles

Tech stock valuations have skyrocketed since the middle of last year, and investor behaviour looks increasingly inconsistent with reasonable investment approaches, unless the framework described above lasts for a long time. Signs of a bubble can be seen in many aspects of the equity market. Retail investors' actively trading in upside options, the ever-growing market caps of a limited number of stocks, and IPO flows are among the numerous signs of a bubbling digital sector. Inflated valuations cause optimistic analysts to change their valuation methods<sup>1</sup>. The fundamental background is nevertheless real, as we are witnessing another phase of the digital revolution, exacerbated by restrictions on mobility and human interaction. But the ultra-low interest rate environment clearly brings valuations back to levels not seen since the tech bubble of the 00s.

### The spark is nearly impossible to predict

Financial market bubbles are difficult to predict and are ex-post concepts. This one might last a few more years, and history shows that market exuberance can persist over a long period. Alan Greenspan's famous speech was made in 1996 and the dotcom bubble had another four years before bursting. In a context characterised by excess savings over investments, interest rates can remain very low for several years, while the digital transition is accelerating. Looking forward, high indebtedness may weigh on domestic demand, the inflation mini-boom might only last for a couple of quarters, while fiscal boosters might also prove short-lived. These would support asset price bubbles in sectors with sustainable growth, such as the green and digital sectors. As these

<sup>1</sup> "Irrational exuberance is the psychological basis of a speculative bubble. I define a speculative bubble as a situation in which news of price increases spurs investor enthusiasm, which spreads by psychological contagion from person to person, in the process amplifying stories that might justify the price increases, and bringing in a larger and larger class of investors who, despite doubts about the real value of an investment, are drawn to it partly by envy of others' successes and partly through a gamblers' excitement." Shiller, Robert J. March 2000 *Irrational Exuberance*, Princeton University Press.

## THEMATIC

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*The bursting of equity bubbles only has a temporary impact on growth*


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conditions may last for a long time, it is not easy to predict the spark that would lead to the explosion, and thus it would probably be suboptimal to reduce exposures too early that said, the recent rise in real rates should be monitored very closely.

### All bubbles do not impact the economy in the same way

We might not be able to tell at which stage of the bubble we are<sup>2</sup>, let alone when it might burst. But we can still make assumptions about its consequences for the financial markets and the economy.

History shows that bubbles can have a different impact on the economy once they burst, regardless of the magnitude of the initial financial shock. **Indeed, the Japanese real estate bubble of the 90s, the Asian credit bubble of 97 and the subprime bubble of 08 have been far more impactful than the 00s dotcom bubble or the Chinese 2015 equity market boom and burst.**

Although every situation is different and it is not possible to have clear-cut categories, bubbles can be grouped into two clusters: equity-driven bubbles and credit-driven bubbles.

- Equity bubbles are based on excess inflows into equities or their equivalent. They mainly have an impact on wealthy households and fast-growing corporates, but little impact on the vast majority of households<sup>3</sup> and non-bubble prone sectors. Moreover, are excess savings driven by over-optimism and over-investment in innovation despite unproved profitability. Therefore, when a bubble bursts, it is a lost opportunity in the future more than anything else.
- Credit bubbles are also driven by excess liquidity but the bubble driver is excess leverage on tangible assets. They involve excessive optimism and over investment in the value of real assets which have an economic utility and usage. These bubbles tend to spread across a wide range of economic agents, including low-income households. When they burst, they generate a loss of economic value today. By definition, these bubbles have a funding element which spreads to the banking sector.

**The very short-term implications of both bubble groups are somewhat similar** (equity market crash and panic selling, bankruptcies and economic recession), **but the economic impact is ultimately very different.** An equity bubble will mainly

shrink the excess savings of already wealthy individuals and stay in the financial sphere with little impact on the real economy, whereas a credit bubble will hurt the middle class. Moreover, capital can be rebalanced towards other sectors or themes or simply saved for a while after an equity crash. The impact on growth is temporary. The 2000 dotcom and Chinese 2015 bubbles were followed by several years of strong economic growth despite significant portfolio losses<sup>4</sup>, not to mention the fact that certain segments of the equity markets proved resilient to the crash. Conversely, a credit-driven speculation with excess leverage leads to negative equity, debt deflation and, therefore, the withdrawal of available capital from the economy, **which has a deep and long-lasting impact on potential growth.**

### Central banks will try to contain the crash

The current situation could be a mix of both equity and credit and the implications might not be as simple as we have just described. However, **there are signs that this is probably an equity-type bubble, at least for now.** The policy response can also tweak the process itself. An equity bubble bursting which stays in the financial sphere with limited consequences for the banking system, for instance, should not theoretically trigger emergency intervention from central banks. In fact, it could be seen as the collateral damage of a prolonged accommodative monetary policy. However, if this shock had broader consequences for the economy, affecting households, corporates, then banks and eventually states, the central banks would try to contain it. Indebted states would not use taxpayers' money to protect speculators. But if it were to become a systemic risk, they would not have a choice. Rising credit spreads coupled with falling equity markets could then trigger a "balance-sheet recession".

Therefore, we can infer that policy makers will watch carefully the boom and burst of what looks like an equity bubble and pre-emptively act to avoid it becoming an unmanageable situation. **The investment implication is a gradual rebalancing away from the highly-valued tech sector into other segments in the current phase and a contrarian positioning during the fireworks.**

*Finalised on 25 February 2021*

<sup>2</sup> See the five stages of the financial asset bubble by Hyman P. Minsky *Stabilizing an Unstable Economy* (1986)

<sup>3</sup> While a majority of Americans have some level of investment in the stock market through retirement accounts, it is estimated that 84% of all stocks owned by Americans belong to the wealthiest 10%. See *Household wealth trends in the US, 1962 to 2016: has middle class wealth recovered?* E. Wolff, NBER WP (2017).

<sup>4</sup> Note however that US real GDP did not post a single year-on-year decline after the bursting of the dot com bubble! (on a quarterly basis, real GDP just declined slightly in Q1 and Q3 2001)

## THIS MONTH'S TOPIC

## China and EM: growth and policy Q&amp;A



**Alessia BERARDI,**  
Head of Emerging Macro and  
Strategy Research



**Claire HUANG,**  
EM Macro Strategist

### Q1. China recorded a surge in Covid-19 cases in January, the worst flare-up in 10 months. How will this winter outbreak affect the growth outlook?

The resurgence of Covid-19 cases in three northern Chinese cities prompted the government to escalate pandemic containment measures aggressively, just ahead of the Lunar New Year (LNY), leading to a plummet in travel during the holiday season.

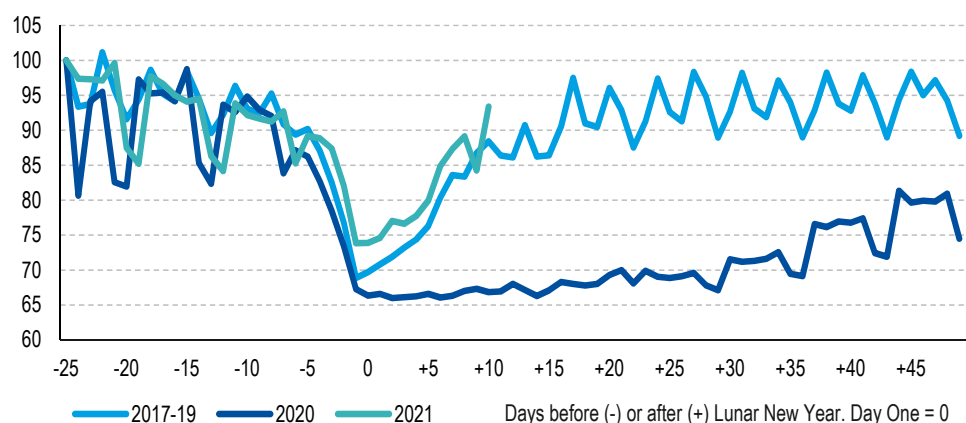
Despite the steep decline in inter-provincial mobility, local mobility and consumption was little affected. Retail sales and catering revenues during the LNY Golden Week (11-17 February) were up 28.7% from a year ago, and 4.9% higher than the same period in 2019. Box offices hit record highs, while auto and property sales held up. Nonetheless, transportation and tourism services were hit hard, pulling the related CPI into deeper contraction.

From the production side, as the majority of migrant workers stay put, the working hour during this holiday season would have been

prolonged. The return-to-work is smoother and earlier than in previous years (Chart 1). High-frequency industrial data, including the refinery operation rate, cargo traffic at ports and air pollution severity, show that production activities were stronger than usual during the LNY holidays.

Since the winter outbreak was contained quickly, we only expect a small set-back in the services sector recovery. As for the industrial sector and exporters, this special staycation would serve as a moderate boost, given the smaller disruption from holiday travel and longer working hours. So far, the evidence to hand suggests that China's economy could avoid falling into contraction again in sequential terms, better than our previous expectation. The low base last year means the Q1 GDP figure could easily show growth in the high teens.

#### 1/ China's city traffic congestion during the Spring Festival



Source: Wind, Gaode, Amundi Research as of 25 February 2021

*The message is clear,  
the PBoC is normalising  
its policy with a  
tightening bias*

### Q2. What happened in China's interbank market? Has the PBoC monetary policy stance changed?

Usually before the Lunar New Year, the PBoC maintains an accommodative stance in the interbank market, to meet the seasonal surge of liquidity demand. As well as its daily go-to tool, the 7D reverse repo, it will also use longer-tenor tools, including 14D/28D reverse repos, 1yr MLF/TMLF (similar to LTRO/TLTRO), or targeted RRR cuts.

Nevertheless, the PBoC had only injected the bare minimum this year (Chart 2). Despite already tight liquidity, it started to net withdraw liquidity two weeks before the LNY break, driving the overnight borrowing rate to a record high since Jul 2013. The term spread (10y – O/N) turned negative

for several days, which has only been seen in April 2018 and June 2013, when spikes in short rates were mainly policy-driven.

Hence, we believe this round of unexpected liquidity tightening is not accidental. It is debatable what the PBoC is actually tightening for, be it the equity market, the housing market or financial arbitrages/leveraged trades in the interbank market. But the message is clear, the central bank is normalising its policy with a tightening bias.

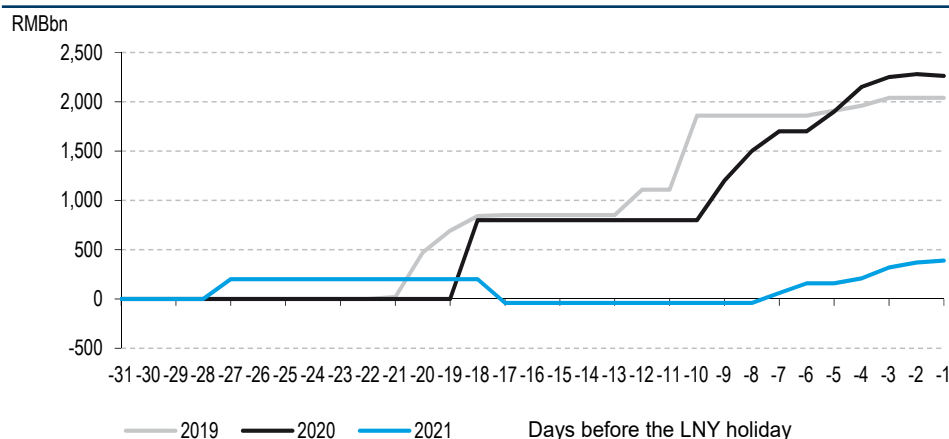
We continue to believe that the PBoC will anchor interbank market rates around its OMO rates for most of 2021, i.e. 7D repo rate at 2.2%, and 1-year MLF rate at 2.95%. But

## THIS MONTH'S TOPIC

we should not be surprised if there is a brief deviation from these anchors. We expect the PBoC to leave the headline policy rates

and RRR unchanged. The risks of a rate hike this year remain low as policy easing has started to withdraw on all fronts.

## 2/ The PBoC's cumulative liquidity injection before LNY



### Q3. What is your expectation for China's fiscal policy in 2021?

With the overarching goal to control the debt-to-GDP ratio, we expect public debt to grow at a slower pace in 2021, and fiscal policy to be less expansionary. Specifically, we expect the headline budget deficit to narrow from 3.6% to 3.2%, which will be announced at the National People's Congress that convenes on 5 March.

The augmented fiscal measure, comprising sales of land use rights in the Government Fund, will be under the spotlight. In 2020, the quota of Special Local Government Bond (LGB) to finance the Government Fund was raised significantly to RMB3.75tn from RMB2.15tn in 2019, contributing to c.1.5ppt of the budgeted deficit expansion. The consensus is forecasting a reduction to RMB3-3.5tn in 2021. In our view, a figure in

the upper range is more likely, amid mounting refinancing pressures of contingent local government debt and increasing cases of local SOE defaults.

The more comprehensive measure to watch is Total Social Financing (TSF) growth, which consists not only of government bonds but also quasi-fiscal lending to the SOEs and LGFVs. Following a decisive acceleration just after the pandemic outbreak, TSF growth started to drift downwards in November 2020. We expect it to remain on a gradual downtrend, slowing by around 2ppt to 11.5% by the end of 2021, which is still higher than the pre-Covid level of 10.7%. At this rate, China's debt-to-GDP ratio will stabilise in 2021 at around 270%, after picking up 23.6ppt from 246.5% at end-2019.

### Q4. Base on the latest macro-financial developments, are EM assets still attractive?

One of the most important drivers for investing in Emerging Markets is growth: not only domestic growth at country level but also global growth reflected in continuous robust external demand either for commodities or for manufacturing products.

Among the leading global growth drivers, we list the US and China. Looking now at the US, we expect a strong economic performance in 2021, thanks to the sizable fiscal package to be unveiled and approved shortly (between \$1<sup>tr</sup> and \$1.9<sup>tr</sup>). Moreover, as a further upside risk to growth, discussions are ongoing about a large infrastructure plan of about \$2<sup>tr</sup>, to start by early 2022.

The current recovery is benefiting oil and commodity exporters, with terms of trade decisively improving in some Latam countries (such as Chile and Peru), as well as manufacturing exporters across the universe with a preference for countries

more exposed to the IT sector and PPE (personal protective equipment), such as Asia and mainly North Asia.

Concerning the services, tourism and hospitality sectors in particular, the recovery is much slower and we will see a more robust rebound once the vaccination roll-out is more global. Countries like Thailand, for which around 11% of its GDP is dependent on tourism, are still struggling to recover. Overall, in the EM, the mobility path is stable or mildly heading upward given that the restrictions are less severe than in certain more advanced economies.

Together with the more positive reassessment of economic growth, another important factor under review is the ability of the main central banks to navigate an environment with extremely accommodative monetary policy and rising inflation expectations, driven by a perceived economic overheating. It is

*We expect credit growth to remain on a gradual downtrend*

## THIS MONTH'S TOPIC

*EM asset classes still offer exposure to high yields, and some exposure to growth at a reasonable price*

worth remembering that a supportive global financial backdrop is essential for continued investment in EM.

Although we are seeing some pressure on prices from costs (commodities, food, shipping rates), the demand side remains subdued; indeed, the great majority of countries have not reached their 2019 growth levels and will take time to do so. Therefore, our inflation outlook is not a source of concern; it should allow the central banks to withdraw their liquidity support very gradually and even more

gradually change their monetary policy stance.

With all the necessary diversification (mindful that the EM universe is very heterogeneous in its strengths and fragilities), EM asset classes still offer exposure to high yields in a world of ultra-low or negative interest rates, and some exposure to growth at a reasonable price.

*Finalised on 18 February 2021*

## Top Asian suppliers of medical goods &amp; materials

Ranking within Asia (2019 data)	Plastic (HS 39)	Rubber (HS 40)	Glass and glassware (HS 70)	Organic chemicals (HS 29)	Pharmaceutical products (HS 30)	Tubular needles (HS 901832)	Syringes (HS 901831)	Refrigeration equipment (HS 8418)
1	China (1 <sup>st</sup> )	China (1 <sup>st</sup> )	China (1 <sup>st</sup> )	China (1 <sup>st</sup> )	India (11 <sup>th</sup> )	China (4 <sup>th</sup> )	China (2 <sup>nd</sup> )	China (1 <sup>st</sup> )
2	South Korea (4 <sup>th</sup> )	Thailand (3 <sup>rd</sup> )	Japan (5 <sup>th</sup> )	South Korea (7 <sup>th</sup> )	China (15 <sup>th</sup> )	Japan (6 <sup>th</sup> )	Singapore (8 <sup>th</sup> )	South Korea (6 <sup>th</sup> )
3	Japan (6 <sup>th</sup> )	Japan (5 <sup>th</sup> )	Hong Kong (6 <sup>th</sup> )	India (8 <sup>th</sup> )	Singapore (17 <sup>th</sup> )	Thailand (8 <sup>th</sup> )	Philippines (15 <sup>th</sup> )	Thailand (7 <sup>th</sup> )
4	Taiwan (10 <sup>th</sup> )	South Korea (6 <sup>th</sup> )	South Korea (12 <sup>th</sup> )	Japan (9 <sup>th</sup> )	Japan (18 <sup>th</sup> )	Singapore (10 <sup>th</sup> )	Hong Kong (16 <sup>th</sup> )	Singapore (14 <sup>th</sup> )
5	Singapore (12 <sup>th</sup> )	Malaysia (7 <sup>th</sup> )	Taiwan (13 <sup>th</sup> )	Singapore (11 <sup>th</sup> )	South Korea (21 <sup>st</sup> )	South Korea (11 <sup>th</sup> )	Japan (17 <sup>th</sup> )	Japan (15 <sup>th</sup> )

*Ranking in parentheses equals global ranking in terms of exported US dollar value in 2019. Sources: ITC, The EIU. Amundi Research as of 25 February 2021*

## THEMATIC

## An expected improvement in corporate fundamentals bodes well for bondholders

**We expect business fundamentals to improve in the coming months, especially for low-rated companies. The ratings momentum in HY, as measured by upgrade/downgrade volumes, has already turned positive.**



**Valentine AINOUCZ,**  
Deputy Head of Developed  
Markets Strategy Research



**Mickael BELLAICHE,**  
Fixed Income and Credit  
Research Strategist

*The ratings momentum in HY, measured by upgrade/downgrade volumes, has turned positive*

In addition to a rebound in profits, companies should continue to benefit from historically attractive financing conditions. Demand for corporate debt is strong from yield-hunting investors. We expect low-rated issuers, in cyclical sectors in particular, to show more balance sheet discipline and to start a deleveraging cycle. M&A activity will be a key variable to monitor this year for well-rated companies.

**Corporate defaults are occurring at a much lower level than initially anticipated**

**This crisis has been characterised by countercyclical credit conditions**, thanks to the very successful coordinated action between governments and central banks. Supportive financial market conditions allowed the most fragile companies to increase their liquidity and avoid default in 2020, despite the exceptional drop in economic activity. The debt supply was massive for corporate and sovereign issuers. Many companies stored unprecedented levels of cash. Maturities have been lengthening, particularly for investment-grade companies. This heavier-than-anticipated supply has been well absorbed by investors: yields hit all-time lows on new issues. This is a big difference compared with previous crises.

**As a result, default rates have remained well below initial expectations.** The trailing 12-month default rate for global non-financial and financial companies stood at 6.6% at year-end 2020, compared with 10.6% projected at the onset of the

pandemic. Defaults are expected to peak in Q1 2021, 12 months from the outbreak of the crisis. A downward trend is then expected to start in Q2 and the following months. Defaults should remain concentrated in specific sectors, mainly CCC companies with vulnerable business profiles, i.e., low structural capacity to generate profits.

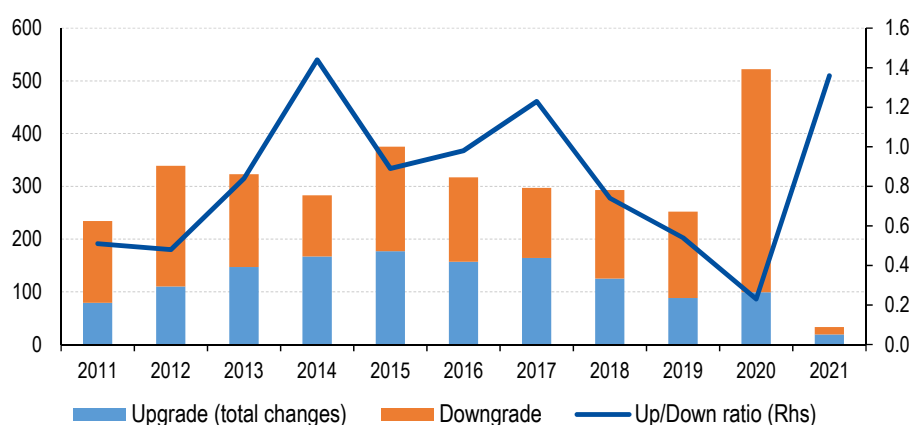
**Corporate fundamentals of low-rated issuers should improve**

**We expect corporate activity to pick up** as the global economy rebounds in the second half of the year, once economies reopen and vaccines are rolled out. This rebound in growth should be supported by fiscal and monetary policies, excess household saving and manufacturing restocking. At the same time, we expect central banks to continue delivering extremely accommodative monetary policy with no pre-emptive tightening. The major central banks are likely to continue supporting economies through low rates and asset purchase programmes.

**At the same time, we expect companies, especially those that are low-rated and from cyclical sectors, to show more balance sheet discipline and to start a deleveraging cycle.** These issuers have accumulated debt due to the decline in economic activity and are now more leverage-constrained.

**In addition, companies should continue to benefit from historically attractive financing conditions.** The record low cost of funding has led to reduced interest payments on debts and improved

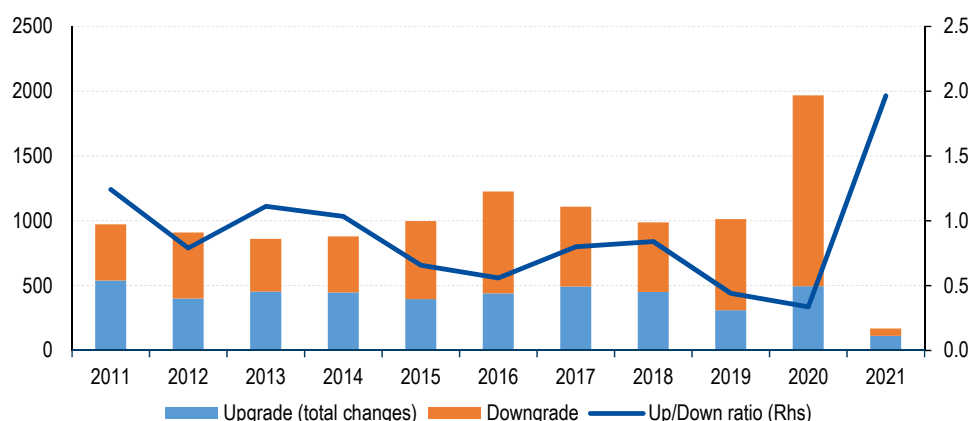
**1/ Euro HY: credit ratings trends**



Source: Bloomberg, Amundi Research - Data as of 25 February 2021

## THEMATIC

## 2/ US HY: credit ratings trends



Source: Bloomberg, Amundi Research Data as of at December 2020

corporate creditworthiness. Activity on the primary market remains solid, mostly for refinancing purposes. The high level of cash on corporate balance sheets is reducing the need for additional funding in the near term.

**A slow recovery would hamper the improvement in low-rated companies' credit profile.** Continued access to liquidity remains crucial for companies facing impending debt maturities in order to avoid default.

#### Strong rebound in M&A driven by the technology sectors

**Despite the crisis, M&A activity remains on track in the United States and Asia.** However, it remains modest in Europe. M&A activity accelerated sharply during the second half of 2020; during this period

volumes were the highest of all 2H periods since 2015.

**This rebound in M&A activity was initially driven by technology,** consumer non-cyclical and communication sectors. These companies have outperformed in recent years and were the big winners from the crisis. Most of them are well-rated and well-capitalised. They have an offensive strategy and pursue external growth to gain in scale and diversity (product, region, customer).

**M&A activity has also resumed for those companies hardest hit by the pandemic** and the economic crisis, for example companies in the energy sector. Their main motivation in this regard is to streamline costs rather than achieve external growth.

*Finalised on 24 February 2021*

## THEMATIC



**Sergio BERTONCINI,**  
Senior Fixed Income  
Research Strategist

*Contrary to previous experiences the peak in corporate spread occurred much earlier than usual, roughly just one month into this short recession*

## Credit spreads vs bond yields in the current cycle

The move in rates is just one factor of the macro backdrop that can drive spread trends, but one that worked quite well in past cycles and therefore worth focusing on in the current recovery phase. Actually, this credit cycle was cut much shorter by unprecedented intervention from central banks and from huge fiscal support, ultimately leading to relevant differences with past experiences, outlined in this piece. Our conclusions are that these differences are probably going to soften the traditional historical relationship.

### The historical link between rising bond yields and credit spreads in the recovery following a recession

Empirical evidence shows that **credit spreads tend to peak at the end of recessionary periods**. Credit then recovers along with rising government bond yields, as bond markets usually start to price in higher real growth rates, increasing inflationary risk, and a change

in monetary policy. The table below, which covers the cycles of the past forty years in the United States, confirms that credit rallies following recessionary phases have always been associated with a substantial rise in bond yields. Furthermore, post-recession credit rallies are more vigorous and run out of steam sooner when bond yields rise sharply, as occurred in the 1980s and 1994.

Recession		BBB spread					US 10yr T-note yield		
Starts	Ends	Peak	Spreads at peak	Trough	Spreads at trough	Change in spreads (b.p.)	At spreads peak	At spreads trough	Change in yield (b.p.)
Dec-69	Nov-70	Dec-70	284	Aug-73	92	-192	6.39	7.40	101
Nov-73	Mar-75	Feb-75	294	Mar-78	101	-193	7.39	8.04	65
Jan-80	Jul-80	Jun-80	282	Sep-81	185	-97	9.78	15.32	554
Jul-81	Nov-82	Oct-82	376	May-84	131	-245	10.91	13.41	250
Jul-90	Mar-91	Jan-91	227	Jul-91	163	-64	8.09	8.47	38
Mar-01	Nov-02	Oct-02	273	Apr-04	130	-143	4.29	4.35	6
Dec-07	Jun-09	Dec-08	525	Apr-10	172	-353	2.20	3.66	146

Apart from empirical evidence, a negative correlation between spreads and yields in post-recessionary phases **does make sense**: a macro and micro recovery means improving credit metrics through increasing cash flow generation, though the best of debt reduction is usually already past at that time. Rising inflation expectations, which push yields higher, also mean better pricing power prospects for companies, and initial rate hikes by central banks usually tend not to harm equities and corporate bonds. Furthermore, spreads offer a cushion to the negative duration effects arising from an increase in bond yields. Therefore, investors still perceive corporate bonds as attractive compared to government bonds in these phases.

### What about the present cycle?

Chart 1) shows the link between 10-yr Treasury yields and US BBB-rated corporate bond spreads in the very latest cycle from before the Covid-19 crisis up to the present day (ultimately a one-year span). Divergences vs previous cycles are significant not only in macro dynamics but also in market behaviour,

which appears quite clearly in the chart. Hereby we summarise three main differences with the past:

**Firstly**, while much more severe than past GDP contractions, the 2020 recession was also quite short, actually lasting just four months from the end of February to June.

**Secondly**, contrary to previous experiences the peak in corporate spread occurred much earlier than usual, roughly just one month into this short recession.

**Finally**, rates started to normalise later than usual, as between February and November the US 10-yr yield moved sideways, within a limited range, and really started to trend higher in December following positive news on vaccines and fiscal packages. In January and so far in February, the trend has accelerated on the back of new expectations of stronger fiscal stimulus and more rapid recovery, following the democratic success at the US Senate run off elections.

Getting more deeply into the numbers, BBB spreads compressed by a remarkable 325bp move from the 465bp recessionary peak touched on March 20<sup>th</sup> to the 140bp area

## THEMATIC

*Differences with past experiences are probably going to soften the traditional historical link between spreads and yields*

by end of November, while over the same period, the 10yr Treasury yield decreased slightly, from 96bps to 84bps, remaining in a trading range. The subsequent move was quite different, as spreads tightened further but to a much lower extent than in the previous phase, namely decreasing from 140bp to 122bp at this writing, actually even below pre-Covid crisis levels. Over this latest period, the corresponding move by the US Treasury was a meaningful increase, as 10yr yield rose by more than 40 bps.

In a nutshell, a period of spread normalisation took place before the yield could start to rise. Monetary and fiscal policies were successful in cutting this credit cycle quite short, both limiting the extent of the spike in spreads and triggering a very rapid compression in risk which started after just one month from the crisis. In simple terms, the best of the credit cycle seems to be behind us (in terms of spread tightening and excess return delivered on government bonds), as the normalisation of credit risk premiums has already taken place, especially relative to bond yields.

At the same time, a milder upward trend in bond yields may take place looking forward if central banks continue to target preserving favourable financial conditions and in light of the move already delivered by fixed-income markets. Therefore, although credit valuations look like headwinds to spread compression and to the renewal of the usual link with rates, we may also expect central banks to keep an accommodative stance in order to avoid extreme moves in curve steepening, which could ultimately endanger the recovery through tighter funding conditions and higher volatility in financial markets. The legacy of the Covid-19 crisis, as we have underlined many times, is a much higher volume of both public and private debt.

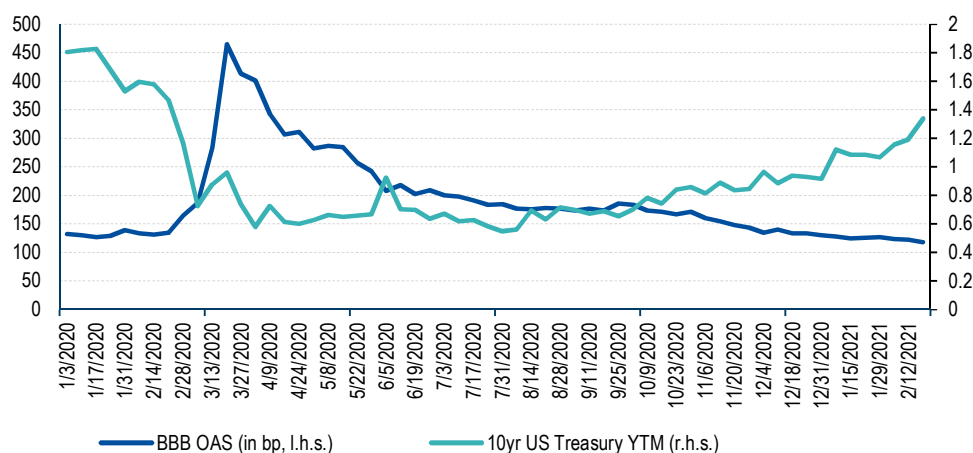
Another peculiarity of this very rapid cycle is the lagged start in the deleveraging

process by companies. The latter has also to do with the success of monetary and fiscal policies in avoiding a credit crunch and ensuring easy financing conditions for corporates, in the US mainly through the corporate bond markets, in Eurozone mainly through the bank loan channel. The economic recovery will support the return to lower leverage levels, sustained as well by the likely gradual use of the huge liquidity buffers built to withstand the economic and financial effects of the crisis, but this process will take some time, as companies entered the crisis with already relatively high debt ratios by historical standards.

### Bond yields and investment flows into credit markets

Historically, the link between retail flows and returns of credit products is a positive one, as returns and flows tend to go hand in hand: sudden and sharp upward trends in rates, affecting credit returns, tended to trigger subsequent outflows. Not only the level but also the volatility of bond yields has to be considered as a potential driver of investment flows from investors, especially in high-beta credit products. Considering this link and the strong growth of retail funds over the last quarters, the risk of an impact from higher rates into flows is present, as this time the capacity of spreads tightening to balance the increase in bond yields looks lower, as we pointed out. At the same time, in our baseline scenario we expect bond yields to move higher but to a limited extent for the reasons already underlined, and at the same time more attractive absolute valuations may finally drive a higher demand from institutional investors. Further, we expect a steepening in the yield curve, but short-term rates to remain anchored by ZIRP for quite some time, reducing the impact and working

### 1/ The link between corporate spreads and bond yields in the current cycle



Source: Bloomberg, Amundi Research, Data as of 19 February 2021

as a sort of absorber of higher rates on low duration credit segments, like the speculative grade one.

### Conclusion

The move in rates is just one factor of the macro backdrop that can drive spread moves, but one that worked quite well in past cycles and therefore worth focusing on in current recovery phase. Actually, this credit cycle was to some extent cut much shorter by unprecedented intervention from central banks and from huge fiscal support, ultimately leading to relevant differences with past experiences, outlined

in this piece. These differences are probably going to soften the traditional historical relationship. But if valuations do not seem to offer the usual scope to compress and therefore to partially absorb the effect of further rising rates, at the same time, support from monetary stimulus and the recent changes in the reaction function of Fed policy to macro factors are expected to contain unwanted excessive volatility in fixed income markets, in order to keep financial conditions easy.

*Finalised on 19 February 2021*

## THEMATIC



**Ibra WANE,**  
Senior Equity Research Strategist



**Debora DELBO',**  
EM Macro Strategist

*A multi-speed earnings season in some regions, but above expectations everywhere*

*Less impacted by the pandemic, Japanese and emerging market results are one step ahead*

## Q4 earnings season: an impressive resilience that supports our pro-cyclical views

**Given the context, Q4 2020 corporate earnings proved resilient. The regions least impacted by the pandemic, such as EM (+25%) and Japan (+20%), experienced notable increases. In the rest of the world, where the pandemic was more virulent, the US still managed to post a positive gain (+4%) while Europe was more affected (-20%). However, even in the most affected regions, the results were far better than expected, with the most significant progress coming from cyclical sectors.**

### **S&P 500: A much stronger than expected Q4 2020, with Financials and the GAFAMs on the forefront**

In the US, of the 80% of S&P 500 companies that had already reported as of February 19, Q4 2020 Blended Earnings (reported + estimates for the remaining) are now seen growing by +3.7%, which is much better than what was expected at the start of the year (-10.3%). Likewise, this marks an improvement versus Q3 (-6.5%) which was not obvious, given the worsening of the sanitary context and the slowdown of the US economy at the end of the year.

From one sector to another, developments were, however, very fragmented, with three sectors in particular that stood out on the rise (Technology + 19%, Financials + 21% and Materials + 22%) and two on the decline (Industry -37% and Energy -105%). But it was above all the analysis of the gaps that was revealing. Thus, while good or bad, the results had been well anticipated in most sectors. It was mainly Financials and Technology in the broad sense that thwarted (in the upward direction) all forecasts.

Between the good performance of market activities and lower provisions than expected, Financials' results thus increased by + 21%, instead of the expected -7%.

But it was once again from the GAFAMs that the surprise came. GAFAMs, which can be found in both IT (Apple and Microsoft), Consumer Discretionary (Amazon) and Communication Services (Google and Facebook), saw their Q4 results jump by + 41%, against + 12% expected.

### **Stoxx 600: Given the context, Q4 results proved relatively resilient. H1 2021 could be at risk but H2 should be significantly better**

In Europe, where nearly 45% of the Stoxx 600 companies had reported as of February 16, results have gradually improved. Whereas on January 1, the consensus was for a decline of -27% in Q4, it was only -20% on February 16. Likewise, the proportion of results exceeding analyst estimates was very high, with a gross and net ratio of 66% and 32% (balance of results above expectations vs. below or

match), far ahead the average of the past ten years (respectively 51% and 2%!).

The most significant increases were recorded in cyclical sectors such as Basic Materials (+ 60%) and Consumer Discretionary (+22%). These two sectors also stood out very favourably in terms of earnings surprises, with results respectively +26% and +31% better than expected on January 1. In addition, other cyclical sectors whose results fell in Q4, such as Financials (-40%) or Industrials (-45%) did much better than expected, at respectively +11 and + 9%.

Given the improving environment and the easy comparisons, Stoxx 600 results should strongly rebound in 2021. But between the timid ramp-up of vaccination campaigns (with the exception of the UK) and the maintaining of severe restrictions, this rebound could be weaker than expected and partly delayed to H2 2021. However, even if the European recovery were to be delayed by some months, it should take hold. Therefore, in our view, without deviating from quality entirely, we should already look at cyclical sectors.

### **Relatively isolated from the pandemic, Japan's results proved impressive**

In Japan, where 98% of MSCI companies have already reported, progress has been even more impressive, with an optical increase in earnings of + 38%! In reality, once restated for Softbank's windfall profits, the core earnings rebound was closer to 20% which remains incomparably better than the cautious consensus expectations of January 1st (drop of -15%). By sector, it is again in Cyclical where progress was the strongest, with an average increase of + 23%, and peaks beyond 50% in Technology, Banks or Building Materials, while sectors deemed Defensives recorded an average increase of + 11% excluding Softbank.

### **Emerging markets' earnings season is not yet very far along but already looks promising**

Although with only 27% of MSCI EM companies have reported as of February 17<sup>th</sup> (Source: Capital IQ), the first indications are very encouraging with,

## THEMATIC

*Given the prospect of an accelerating recovery, enthusiasm for growth stocks should decrease*

overall, a double-digit earnings growth (in USD, +45% reported and +25% blended) and +7.5% higher than on January 1<sup>st</sup>.

By country, the biggest gainers were Malaysia (+400%, thanks to the Health Care sector, but still only 21% of the companies reported), Korea (+99%, with 60% of the companies already reporting) and Saudi Arabia (+89%, with 39% of the companies already reporting). On the other hand, Poland, United Arab Emirates, Qatar, Indonesia, Philippines and Thailand continue to post negative earnings growth. At the sector level, Health Care, Materials and Consumer Discretionary made a strong showing on average on all the countries.

Our expectations for 2021 have been revised further up (from 16% to +24% in USD). From a regional standpoint, earnings growth in the first half of 2021 will be more concentrated in Emerging Asia, more resilient in the recovery and much more linked to booming e-commerce profits. The laggards, starting with EMEA (Russia) and then Latam, are unlikely to return to positive YoY numbers until the second half of 2021.

**These good results received without real enthusiasm could become an opportunity...**

Overall, the Q4 earnings season has proven to be remarkably resilient. However, these good results have been met with mixed reactions.

This is particularly the case in the US, where, within a few weeks market concerns have shifted from doubts about the recovery to a possible overheating, or even a revival of inflation. In response, long yields tightened. The UST 10-year yield, for example, surged from 0.9% at the start of the year to 1.20% in mid-February and could range between 1.50 to 1.8% over the year according to our central scenario.

If it goes not substantially higher than that, this should favour rotation but do little to hamper the equity markets. In the US, from a thematic point of view, this would confirm our preference for Small Caps and Value, which should be the main beneficiaries of the recovery. Conversely, in such a context, Growth and Quality would be less sought after. In Europe, Small Caps and Value should also benefit from the recovery. However, as the recovery is not as far along as in the United States (due to greater restrictions and delays in vaccination) and doomed to remain weaker (due to less stimulus), we will also continue to focus on Quality.

*Finalised on 21 February 2021*

## THEMATIC



Tristan PERRIER,  
Global Views

*Pro-supply economic reforms may be difficult to implement in the post-crisis social and political environment*

## Covid, productivity and long-term growth: further secular stagnation or positive reversal?

While the spectacular Covid shock may easily lead to exaggerate extrapolations, it cannot be ruled out that it will matter for long-term productivity and growth. However, the effects could work both ways. Reasons why the current crisis could further worsen “secular stagnation” are many, yet there are also a channels through which it could work positively.

Since the 1970s, productivity gains in the developed economies have gradually slowed (from around 2% per year to less than 1% in the 2010s), despite intermediate cyclical rebounds (at the end of the 1990s in particular).

Several reasons have been put forward to explain this slowdown, some linked to **supply** (de-industrialisation, the low contribution to productivity from information technologies), others to **demand** (ageing, loss of confidence following crises, over indebtedness, inequality) and others still to **measurement issues** (difficulty in factoring in the increasingly rapid appearance of new products and services).

It cannot be taken for granted, at this point, that the current crisis will have a long-lasting effect, positive or negative, on productivity growth (as well as on the other components of the broader economic “secular stagnation”). The spectacular 2020 shock may have created an environment conducive to excessive conclusions about its capacity to alter well-entrenched trends that stretch back several decades and are underpinned by many factors.

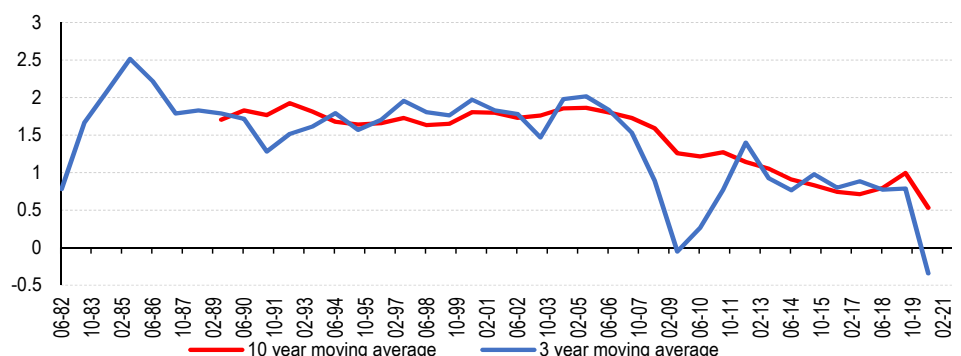
Because something is uncertain, however, does not mean it is impossible, and some aspects of the Covid crisis do seem enough to warrant reflection at the very least on their potential long-term effects on economic growth. Lasting changes could affect each component of a traditional production function: Total Factor Productivity (TFP: productivity of both labour and capital), capital inputs and labour inputs. Some of these changes may be negative and some positive.

From the perspective of TFP, some negative consequences of the crisis may

indeed affect long-term productivity growth, while others could be limited to “level” (one-off, even though permanent) effects:

- The possibility that the crisis will lead to social tensions or political changes that reduce the likelihood that governments can or wish to implement “pro-supply” policies. Such policies, which generally involve reducing the protection of incumbent players against new competitors on the labour, goods and services markets, are widely considered to generate lasting positive incentives for productivity.
- The potential acceleration of deglobalisation, making companies less exposed to international competition, and therefore with less incentive to permanently improve their processes to maintain competitiveness, and less opportunities for massive economies of scale.
- The “zombification” process associated with prolonged public support for non-viable and uncompetitive companies, which would lead to protracted sub-optimal allocation of capital and labour resources, and possibly also a deterioration in skills. Note, however, that while often mentioned, this process would need to remain several years to have more than cyclical and level effects (i.e. slowing down the recovery after mitigating the recessionary shock, and causing one-off skill attrition) and really alter long-term productivity growth. If maintained over the long-term “zombification” could then be very much part of the first channel (lack of pro-supply policies).

### 1/ OECD countries: annual productivity growth, % 3 Year and 10 Year moving averages



Source: OECD, Amundi Research - Data at the end January 2020

## THEMATIC

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*Education disruptions during the crisis may have lasting consequences*


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- **The possibility that the disruptions to the educational system during the crisis will have a negative impact on professional skills when current students (or school dropouts) enter the labour force.** However, this is another factor that may concern more the level of productivity a few years after the crisis than its long-term growth (indeed, while it is well documented that a more educated population is more productive, it is more debatable whether it can grow its productivity faster over time).

**From the point of view of capital inputs, at least two factors could have a negative impact:**

- The **high levels of debt**, together with **durably shaken confidence** could hinder risk-taking and investment and therefore the long-term pace at which new capital is built.
- An **increase in bankruptcies** as we exit the crisis would add a negative level shock through the premature attrition of productive resources that may not find other takers.

**Concerning labour inputs, at least three negative drivers may also be identified:**

- **Less immigration** linked to the fact that professions employing a high proportion of immigrants have been significantly impacted by the crisis yet also, on a more lasting basis, by the possibility that social or political tensions following the crisis could lead to anti-immigration policies.
- A level shock could be added by workers **permanently shifting out of the labour force** after the prolonged Covid-related inactivity period.
- The crisis could also have **negative consequences for the birth rate**, with a long-term impact on the active population.

**Finally, in addition to supply factors in the production function, it is possible that growth will also be durably affected by structurally low demand.** This could stem (as with the reduction in investment) from more prudent behaviour trends (higher saving rates) due to low confidence or high debt levels. It could also stem from an increase in social inequality (greater concentration of revenue and wealth among populations with a high savings rate).

**That said, there are other effects of the crisis that could favour long-term growth, notably via an increase in the TFP.** In this case, we can also identify several factor categories:

- The opportunity provided by the crisis of **testing and developing multiple “disruptive” new technologies and forms of organisation.** Massive use of online work, education and shopping, as well as medical innovation, are the most obvious illustrations. In reference

to innovation cycle theory, it is notably possible that the crisis speeds up the widespread “diffusion phase” of information technologies which had previously been in “discovery phase” and, therefore, had not yet generated the bulk of their potential contributions to productivity.

- **Some extended potential implications of home working** (in addition to the gains or loss in productivity of the employee concerned) on **businesses** (lower costs, access to a much broader pool of skills, new relocation and offshoring possibilities) and on **territorial organisation** (potential opportunities to circumvent transport congestion and housing shortages that impair work and skill mobility).
- The possibility that major **public stimulus plans will, in addition to their demand-supporting role, effectively target innovation** (an ambition clearly stated in the case of the European NGEU plan, for instance).
- **A potential “natural selection” effect through the elimination of weaker companies** (presumably less productive) once the public protective measures are discontinued. This process could, however, be less relevant than during past crises, since Covid is an exogenous factor that has impacted companies primarily, even those that are well managed, depending on their sector of activity.

**As such, in addition to bringing a number of negative one-off shocks to TFP, capital and labour, the Covid crisis could carry very contradictory forces for long-term productivity and growth. It is probably too early to draw conclusions as to their strengths and even more so their net effect, particularly since the Covid crisis is not yet over (if it were to become protracted, causing more damage yet also more incentives for adaptation, its long-term growth effects would probably only become more ambiguous).**

**It seems nevertheless fair to assume that the policies implemented by governments in the immediate aftermath of the crisis will play a significant role in this tug-of-war between positive and negative long-term consequences. In light of the points set out above, the main challenges for public authorities in extracting as much positives as possible are likely to be 1/ keeping some “pro-supply” reform momentum alive; 2/ ensuring that substantial support for demand can be maintained without crystallising rigidities; 3/ ensuring that stimulus plans are at least partially directed towards harnessing productive “disruption” (against a backdrop where there will probably be strong political or lobbying pressure to use them to other ends).**

*Finalised on 18 February 2021*

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*Teleworking could have significant implications on housing and mobility bottlenecks*


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## CENTRAL &amp; ALTERNATIVE SCENARIOS

## Monthly update

This month, we maintain the probabilities and narrative of our central and alternative scenarios. We confirm our constructive medium-term view on the “financial recovery regime”, with more caution in the short-term on financial markets, given the virus-dependent news flow and inflation concerns..

**DOWNSIDE SCENARIO**  
**15%**
**Secular stagnation**
**Analysis**

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

**Market implications**

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

**CENTRAL SCENARIO**  
**75%**
**Multi-year and multi-speed recovery**
**Analysis**

- Multi-year process to get the world economy back on track, with a bumpy road to recovery
- Relapses in economic growth, due to virus outbreaks and lockdown measures until 4Q21
- Massive vaccine rollouts in 1H21 though uneven across regions
- Strong political commitment to mobilise fiscal policies in AEs, but timely execution is a risk
- Accommodative monetary policies continue to support the recovery, cope with deflationary risks and rising public debt
- Positive momentum in corporate earnings and diminishing solvency risks
- Ratio of global trade to global GDP slips further but lower geopolitical tensions after the US elections
- The Covid crisis to exacerbate income and wealth inequalities (risk of increased social tensions)

**Market implications**

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

**UPSIDE SCENARIO**  
**10%**
**V-shaped recovery**
**Analysis**

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

**Market implications**

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

## TOP RISKS

## Monthly update

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

## ECONOMIC RISK

20%

- **Covid-19 vaccine rollout issues**
  - Unexpected logistic or side effects issues of the vaccine could have a very negative impact on investors and business sentiment, which has improved significantly since November 2020
  - One or several virus variants that would make existing vaccine ineffective would undermine the expectations of an end soon to the pandemic
- **A protracted recovery with multiple relapses** might hit business and consumer confidence, looping in sectors that have not yet been directly hit by the pandemic, such as financials
- **Underestimated hysteresis effects in the labour market**, with rising unemployment and uneven impact, could undermine the recovery and generate social tensions
- **A rebirth of inflation and a second “taper tantrum”**
  - The risk is very low in the short run, but upward inflation pressures could build up over time, as the epidemic fades away
  - QE programmes may become problematic when inflation enters the equation
  - Inflation dynamics and central banks reaction function could be sources of uncertainty, in particular in EM, where inflation is close to CBs target
  - Federal Reserve early exit or miscommunication could lead to a second taper tantrum similar to 2013

## FINANCIAL RISK

15%

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

## (GEO)POLITICAL RISK

10%

- **US/China cold war**
  - Post US elections the hawkish tone from Democrats maintains uncertainties regarding the relationship with China
  - The delisting of Chinese companies might trigger similar retaliation
  - Possible accidental confrontations in the South China Sea or the Taiwan Strait
- **Instability within, and among, EM countries** on the back of chaotic virus crisis management
- **The pandemic evolution is still one of the most important risk for EM growth**, as vaccine rollouts are quit slow
- **Global financial conditions getting tighter mainly through US yields**, could revamp the case of EM external fragility when the domestic MP stance are still extremely dovish
- **Post-Brexit**
  - 2020 ended with an exit deal but implementation of it might prove to be a lot more disruptive than anticipated
  - The City might lose market share faster than expected
  - More friction on the boarder of Ireland and tensions within the Union (election in Scotland)
  - UK exploiting the divergence and looking for competitive behaviour across the EU which would potentially undermine the EU cohesion



Cash, linkers, JPY, Gold, USD, Defensives vs. Cyclical



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



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



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



Oil, risky assets, frontier markets and EM



Oil, risky assets, EMBI

## CROSS ASSET DISPATCH: Detecting markets turning points

## How to read the turning point assessment

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

● ● ● **ECONOMIC BACKDROP**

- Economic activity in the Eurozone remains heavily impacted by the Covid-19 restrictions, as confirmed by both soft and high-frequency data. Divergences at both national and sector levels remain evident, with Spain holding up better than Italy, France and Germany, thanks to less strict restrictions. Similarly, the manufacturing sector continues to outperform services. The consensus progressively reverts downward, while economic surprises are stabilising after upticks on better-than-expected Q4 GDP data.
- In the US, after a deceleration in Q4 2020, economic activity is progressively gaining back momentum, supported by the new fiscal stimulus. Both high-frequency and soft data highlight sound private-sector business activity, with manufacturers and service providers reporting expanding business activity. The consensus keeps moderating progressively, with the economic surprise indexes trending alike.

● ● ● **TECHNICALS**

- The “risk on” tone which started with the US fiscal stimulus expected and then confirmed by the Biden Administration, should continue in 2021.
- Signals of overbought risky markets, which materialised weeks ago, have faded a bit as RSI indicators look less stretched now and markets are in a consolidation phase

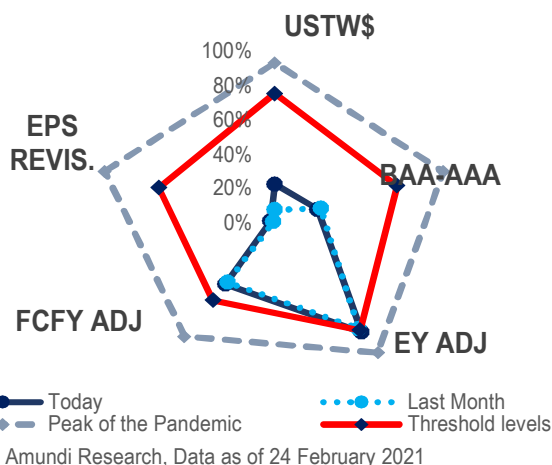
● ● ● **FUNDAMENTALS & VALUATION**

- After a strong YtD performance risky assets are discounting solid growth expectations and profits recovery.
- Equities’ absolute PEs are still above their historical averages, though they are expected to revert going forward as profits rebound.
- The equity risk premium and PE adjusted for CB liquidity injections are less in favour of equities in relative value terms, as interest rates have moved higher and reached important technical levels.

**DEFENSIVE  
ASSET  
ALLOCATION**
● ● ● **SENTIMENT**

- Financial conditions remain benign despite some tentative signs of CB normalisation due to the economic recovery and vaccine roll-out.
- The USD downward trend and improved perceptions of credit conditions are the key supports for our CAST indicator, which shows a limited probability of a sell-off (CAST OFF probability < 10%).
- Additional supports come from our flow-based risk indicator, suggesting that investor appetite remains high at cross-asset levels (equities and commodities are the segments with a higher risk stance).

## Cross Asset Sentinels Thresholds (CAST) still supportive

**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 Economy: assessing the stimulus package impact on growth and inflation**

- The introduction of a new fiscal package in the \$1-1.2t range would likely move the growth outlook above 6% Y in the US, with implications for higher average inflation but not for dynamics, which would be tamed by persisting high labour market slack.
- While the output gap would close by the end of 2021, the labour market slack would be absorbed more slowly, which would limit core domestic inflationary pressures. The core PCE overshoot would only be temporary.
- A bigger \$1.9t package would bring upside risks to real growth and would lift the Core PCE more steadily in line with the Fed target.

**2 US Treasury long-term yields have further upside potential**

- The pro-cyclical fiscal policy, with additional fiscal stimulus in sight, and an accommodative monetary policy will support reflation trade, allowing real rates (at the long end) and breakeven inflation rates to move higher.
- The latest CBO projections released in September 2020 foresee a deficit of around 8% of GDP for 2021. When adding the \$900bn agreed package and a potential additional \$1tn, the 2021 deficit could go up to 17%.
- US 2s10s and 5s30s are expected to steepen further, driven by the real curve and higher debt issuance.
- Amundi UST 10y range for 2021 is 1,5 to 1,8%.
- Long-end breakevens have more upside potential in the medium term due to the size and speed of the economic recovery and the Fed's move to a Flexible Average Inflation Targeting (FAIT).
- We remain confident the long end will move higher. As such we don't rule out the possibility of the Fed implementing a YCC.

**3 Risk assets expected to remain positive on a 12-month fwd basis**

- We expect single-digit returns given our assumptions on the economic cycle and valuations.
- The current recovery phase of the economic cycle is pro-risk although with fatter tail risks than in the past due to uncertainties related to the pandemic.
- Valuations are higher as in previous recovery cycles due to central banks' ongoing monetary policy support, which leaves less room for rerating.
- Based on macro financial cycle projections (Advanced Investment Phazer) and top down valuation (fair value models), we expect single digit upside for most risky assets.

**4 Super Mario in the driving seat to relaunch Italian economic growth**

- Mario Draghi's appointment and the technocrats assigned to the strategic roles (ministry of digital economy, infrastructure, environment...) have been welcome by the market. This will secure the NGEU implementation process.
- BTP-Bund spread at the lowest, which renews equity investors appetite.
- Key challenges: having the "all in" government at play and maintaining cohesion across a multi-facets government.
- Italy will lead the next G20. Draghi will play a big global role in leading the meeting: multilateralism, environment and inequalities will be top priorities in the agenda.

**Covid-19 situation update**

by **Pierre BLANCHET**, *Head of Investment Intelligence*

The outbreak continues to expand across the globe with at least three active variants, more than 110m confirmed cases and 2.5m deaths according to the WHO. The Americas have overtaken Europe in number of cases and the US death toll has passed 500k. However, the trend has been reversing for several weeks, giving some hope to the Biden administration, despite the risks of another wave.

The vaccine roll-out continues. Israel is leading the race with more than half of its population having received at least one dose, follow by the UK (25% according to OWD<sup>1</sup>). Vaccination programmes are taking place at different speeds across the globe, and Europe is still suffering from production delays and logistics issues.

More than 15 vaccines are now available. Johnson & Johnson should get US FDA approval of its single dose refrigerated (easy logistics) product soon, which could be produced at a pace of 1bn+ doses this year. Studies show that the Pfizer and Moderna vaccines are less effective against the new coronavirus variants although at a level that would give some immune protection.

To shed light on the geopolitics of the vaccination, we compiled a sample of the countries that have reserved enough vaccines to cover more than half their population (above 15 years old). DM countries fully rely on North Am. & European providers. More than half of doses delivered in EM countries come from North Am. & European companies, followed by China (32%) and Russia (14%). Globally, North Am. & European firms contribute to 88% of the sample demand while China and Russia combined account for less than 12%<sup>2</sup>.

<sup>1</sup> Oxford's Our World in Data

<sup>2</sup> Source : Duke Global Health Innovation Center, data as of 15th February 2021

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