Research

#04
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CROSS ASSET
Investment Strategy

CIO VIEWS

Bubbles, tantrums and the revenge of value

THIS MONTH'S TOPIC

Fixed-income markets: from cyclical to structural challenges

Confidence must be earned

Amundi
ASSET MANAGEMENT

#04 - April 2021

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CIO VIEWS

Bubbles, tantrums and the revenge of value

Pascal BLANQUÉ,
Group Chief Investment Officer

Vincent MORTIER,
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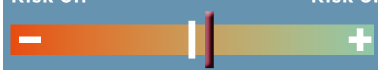
A big shake-up is under way in bonds – rising UST yields, a steepening yield curve (2-10Y) and inflation expectations are leading markets to question whether we are facing a taper tantrum 2.0. **We think that the risk of the Fed taking pre-emptive measures to stop its buying programme** in the next 12 months **has been exaggerated**. The Fed will remain cautious and downplay inflation risks. Therefore, we could see a healthy increase in yields, driven by expectations of a recovery. US inflation now seems to be having a technical rebound, driven by base effects and ISM input prices, but viewing this as only a short term pattern could be a mistake. Once these so-called base effects fade, markets will realise there is something more structural to inflation. The era of low growth, low inflation and zero rates forever is coming under attack, with a new narrative emerging: inflation is returning. On the other hand, CBs and governments need money to help challenged businesses survive, create new jobs and finance projects to address inequalities and climate issues. Fighting inflation is not the top priority, with the focus on full employment.

With CBs unable to withdraw support measures, we are progressively moving towards a new regime, one we call the road back to the 70s. A change of regime often occurs with a change in the mandate of CBs as in the late 70s. However, markets are expecting that CBs will be able to control the yield curve FOREVER. This is wrong as new priorities may force CBs to move into uncharted waters. The second phase of this sequence should be less benign for bond yields and lead to a rebalancing of risk premia. Keeping these backdrops in mind, there are some key questions investors should address:

- **How to manage bond allocation with rising yields?** The rise might not be over yet, but the path of acceleration should slow. Looking at the 2013 taper tantrum, more than two-thirds of the bond correction happened in the first three months. That situation appears to be repeating itself in early 2021. Bonds move ahead of a confirmation of change, and that confirmation should occur in the summer. Investors should stay underweight duration, retaining the flexibility to readjust at higher rates. Opportunities are available to extract value in credit, relative value across regions, and across yield curves. This favours a flexible and unconstrained approach in fixed income investing.
- **Will higher bond yields trigger a bubble burst in equities?** Higher UST yields are important to watch for bonds as well as equities. The gap between the US dividend yield and long-term rates is zero, a sign that a repricing in equities was expected. There is also an element of irrationality in the strong equity performance in the first weeks of 2021. What we see now is a clean-up of some excesses, but certainly not a bear market. The equities outlook remains constructive, but returns are becoming less interest rate-driven and more real economy-driven. For investors, equities remain a key asset class in a recovery phase, but they should avoid expensive areas vulnerable to higher yields.
- **Will value's revenge last?** The yield repricing is driving a rebalancing towards value. The first leg of this rotation occurred in November 2020, triggered by an acceleration in the vaccine situation. Now we are seeing a second leg, driven by rising rates. We will have to wait and see how this situation unfolds as inflation and the economic acceleration are confirmed. Investors may seek further opportunities in value, with a cyclical tilt, to benefit from the multi-year rotation.
- **With rising yields, is the EM case still valid?** EM assets are sensitive to USD and US rates but EM are now in much better shape than in 2013 with regard to inflation and current account imbalances, especially the 'Fragile Five'. EM bonds could play a key role as income engines in global portfolios. We remain constructive in the medium to long term on EM HC debt, but we remain defensive in the short term. The same applies to FX, which has the potential to outperform the USD on a bearish USD medium-term view but the short-term outlook is less benign, as the USD may strengthen. EM equities are the favoured EM asset – exposure to growth at decent prices and a positive earnings outlook.
- **Higher inflation challenges traditional diversification,** as correlations between equity and bonds turn positive. Investors should consider increasing their allocations to assets such as inflation-linked bonds, real assets (real estate and infrastructure) and commodities.

To conclude, in a world of stretched absolute equity and bond valuations, relative value is the only value left in markets. Investors should look at relative value 'within' and 'across' asset classes. In this respect, absolute return approaches that seek to extract relative value in markets, with limited directional risk, could help enhance diversification.

Overall risk sentiment



Constructive on risk assets, preference for equities over credit, relative value. The speed of change of UST yields, real rates to be monitored

Changes vs. previous month

- Cautious, active on duration; positive on inflation in the US
- Defensive on EM debt and FX near term, given rising US rates and USD strength

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

MACRO

Value vs. growth: how to benefit from the rotation

Monica DEFEND,
Global Head of Research

Éric MIJOT
Head of Developed Markets Strategy Research

The value vs. growth rotation is supported by the economic reopening. Some long term arguments also play in favour, but it will not follow a linear, straight path, thereby justifying the need to stay active

Joe Biden's stimulus package of $1.9tr has caused an acceleration of the increase in long-term rates and thus strengthened the value theme (MSCI World Value +4.7% since the start of the year, compared to -2.5% for the MSCI World Growth on 15 March). The mechanism is well known: the increase in rates accompanies the economic recovery, which is favourable to cyclical stocks and its corollaries, small stocks and the majority of value stocks. Conversely, it weighs on stocks with a longer duration (growth), through the discounting of future, long-term profits.

We believe that this rotation has the potential to go further.

A new investment cycle started at the low point of the equity markets on 23 March 2020. This first, pro-cyclical phase was accompanied by a rebound in commodities, which usually lasts at least two years, and by rising inflation expectations that support the idea that nominal economic growth will recover. As usual, small caps were the first to benefit.

However, value stocks, found primarily in the financial and energy sectors, with well-known structural challenges (digital transformation, regulation, low interest rate regime for the first, ecological transition for the second) lagged.

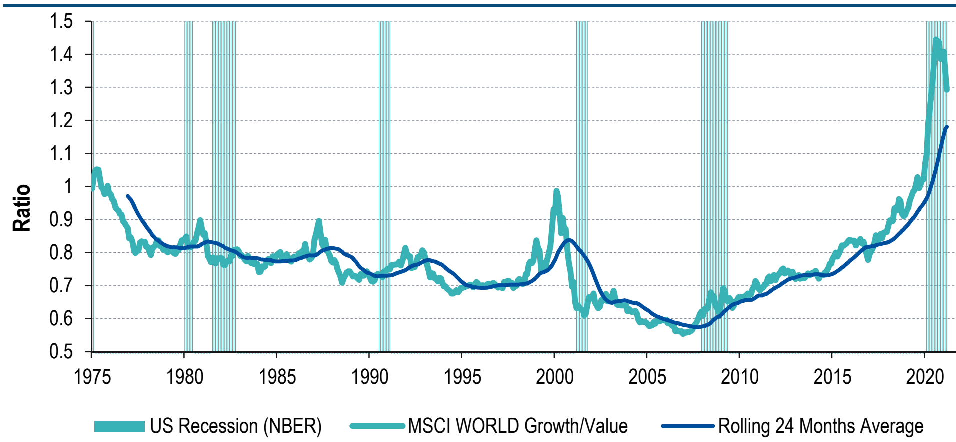
The acceleration of the rise in long-term interest rates, this time via real interest rates, which weigh on risk premiums and therefore on the discount rate, has more recently favoured this shift from growth stocks to value stocks. As their profits have been severely tested during the recession, the latter will also generate higher profit growth than growth stocks over the next 12 months (+34% for the MSCI World Value against +24% for the MSCI World Growth, according to IBES). Finally, the historical valuation gap between the two indices, which is higher than it was in 2000, suggests that the trend may continue.

Having said that, we believe it will be necessary to progressively favour an active approach to take full advantage of the great value rotation.

There are very long-term arguments in support of value: its high discount, a future acceleration of inflation, the return to more growth (productivity gains and decarbonisation investments, a less unfavourable demographic factor in a few years' time, etc.). Nevertheless, the path is likely to be chaotic. In this respect, we note that when the MSCI World Growth/Value ratio falls below its 24-month average, it tends to bounce back towards it (see chart), sometimes even violently. Breaking an established order can take time. If we believe there is still about 10% to go until the ratio reaches its average — that appears quite comfortable — we may come to a tipping point a little later that underpins the need for active management to get past that point safely.

There are a few elements that support this view: 1) at about 2% on US 10-year yields, taking up duration could become tempting; 2) if inflation rises, the pricing power theme, which is favourable to certain growth stocks (luxury, some Big Tech, etc.), could come back into fashion; and 3) long-term themes (green plans, digital, ESG) could benefit from interesting entry points. **In conclusion, we believe that the value style could go further in this cycle and that it will be necessary to progressively focus on relative value**, which plays into the strengths of active management.

MSCI World Growth/MSCI World Value ratio



Source: Amundi Research, Refinitiv, as of 15 March 2021.

MULTI-ASSET

Recalibrate risks within the "pro-cyclical" paradigm

Matteo GERMANO,
Head of Multi-Asset

With growth narratives confirming our moderate risk-on stance, we see opportunities in DM equities and a realignment in the EM FI and FX spaces

The economic environment is supportive of risk assets and we continue to play on reflation but are aware of consensus risks, the growth divergences within DM and between DM and EM, and some high valuations. The recent pullback in equities in certain areas and the increase in bond yields has been more of a recalibration of multiples, but it is not a structural de-risking and may provide attractive entry points for active investors. Thus, staying agile and selective is important as there are opportunities across the spectrum in equities, credit and FX in developed and emerging markets, though investors should adjust their positions due to the headwinds from rising US rates.

High conviction ideas

With an overall constructive view on equities, we remain neutral on Europe and the US and **positive on Japan and Australia.** In the first, we have upgraded UK domestic stocks owing to their exposure to the reflation theme on the back of the vaccination programme, a demand resurgence and improving earnings. Their asymmetrical profile and the large weight of defensives offer a cushion against what has become a consensual recovery trade. In EM, we remain optimistic but recommend some adjustments in China to emphasise more the value strategy and financial names amid the country's improving economic environment.

On duration, we remain neutral on the US and Europe, but are positive on US inflation. Despite the recovery in valuations, potential targets point to a further appreciation of inflation expectations from current levels. Even in the UK, the latest consumer price report and an expansionary fiscal policy paints an optimistic picture for inflation, leading us to stay positive on our 2-10Y yield curve steepening strategy. On peripherals, we are constructive on the 30Y Italy vs. Germany spread owing to supportive technicals and valuations, as well as positive political developments. We expect ECB support to continue for Euro markets as President Lagarde clarified that bond buying will happen at a "significantly higher pace than during the first months of this year." **We remain overall constructive on credit** but have slightly downgraded IG and recommend investors look for better entry points given that the potential for further spread compression looks limited compared with HY, which still offers some space for spread tightening, and attractive carry. Even though IG remains resilient against market volatility amid the ECB's support, rising bond yields could affect flows into the asset class. Moreover, we believe the relationship between rising yields and IG spread tightening — an improving economy causes bond yields to rise and corporate credit metrics to improve — could weaken.

EM debt is a way to prop-up 'smart income' over the long term but we realise that EMBI spreads are close to fair value, with some tightening potential in HY, whereas valuations are expensive in IG. As a result, we have marginally downgraded EMBI due to rising US rates and accelerating outflows from HC debt. Nonetheless, we suggest adjusting USD hedges and protecting US duration exposure amid higher US growth and inflation dynamics. **On FX, investors should remain constructive** – stay positive on BRL and RUB but now through the JPY and EUR respectively, in light of the strengthening dollar. We are now cautious on MXP/USD, KRW/USD and CNY/USD (limited upside). While the KRW was downgraded due to concerns over outflows, the RUB remains supported by growth, inflation expectations in Russia and the strong oil price. On DM, we keep our positive view on CAD/USD and NOK/EUR, as well as our cautious stance on CHF/GBP and CHF/CAD.

Risks and hedging

Inflation and UST yield movements are key risks that may alter the attraction of equities vs. bonds. We advise investors to maintain hedges in the form of derivatives to safeguard equities exposure, credit positions and US duration. We have downgraded gold owing to rising real rates and growth expectations.

Amundi Cross Asset Convictions

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

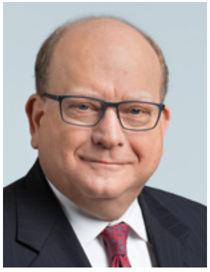
Source: Amundi. The table represents a cross-asset assessment on a three- to six-month horizon based on views expressed at the most recent global investment committee. The outlook, changes in outlook and opinions on the asset class assessment reflect the expected direction (+/-) and the strength of the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

FIXED INCOME

Play the recovery, play credit and inflation

Éric BRARD,
Head of Fixed Income

Yerlan SYZDYKOV,
Global Head of Emerging Markets



Kenneth J. TAUBES,
CIO of US Investment Management

The Fed is unlikely to engage in a taper tantrum to ensure easy financial conditions, but the era of low inflation and low rates may not return as we are at the start of a 'regime shift'

The ongoing recovery allows us to maintain our positive view on risk assets, but this recovery is likely to be characterised by divergences in growth rates, with the US-EU gap widening. This has caused inflation expectations and 10Y yields to rise. Going forward, markets are expecting that once the impact of the current 'base effects' on inflation subside, yields and inflation will return to low levels. However, we believe something more structural is happening with inflation in long run. **Given this backdrop, investors should remain active on rates** and USD movements and their effects on EM assets. Credit remains a source of income, amid hopes of improving metrics and CB support, but selectivity is crucial.

Global and European fixed income

We remain cautious on duration across the board, particularly in the US, core Europe, Canada and the UK. On peripheral debt, we keep our positive stance, mainly through Italy 30Y, but recommend investors explore opportunities across the entire curve. We are also actively following US and Euro yield curves, as the former continues to steepen on high inflation, which may be hedged through breakevens. The latter presents opportunities to lock in some gains but investors should stay overall positive on 10Y and 30Y US, and neutral on Europe. We now believe the 10Y Australia breakeven presents value amid the improving economy and inflation expectations there. **We are optimistic on credit** due to fundamentals and forecasts of low default rates, but the impact of rising real yields must be monitored. **We favour shorter duration debt (3-7Y) over longer maturities (more sensitive to rate movements).** Our preference is for financials – subordinated debt vs. senior, HY vs. IG.

US fixed income

Fiscal stimulus and infrastructure spending are likely to raise growth projections and, accordingly, we remain defensive on USTs (steepening yield curve, increased debt). Investors may look to reduce interest rate duration exposure with the option to tactically add if valuations look appealing. However, TIPS are an attractive diversifier.

A strong consumer should boost pent-up demand in H2 and is already supporting the housing market, even as labour data is improving. We remain positive on housing, agency mortgages and securitised credit, but in the last one the volatility is high, so some prudence is essential, especially at the top of the stack where valuations are expensive. Importantly, higher rates are driving consumer expectations for duration extension, which could be a risk for investors. Thus, the need for monitoring and selection is high. We are constructive on corporate credit, but think investors should limit IG duration to reduce portfolios' sensitivity to higher rates.

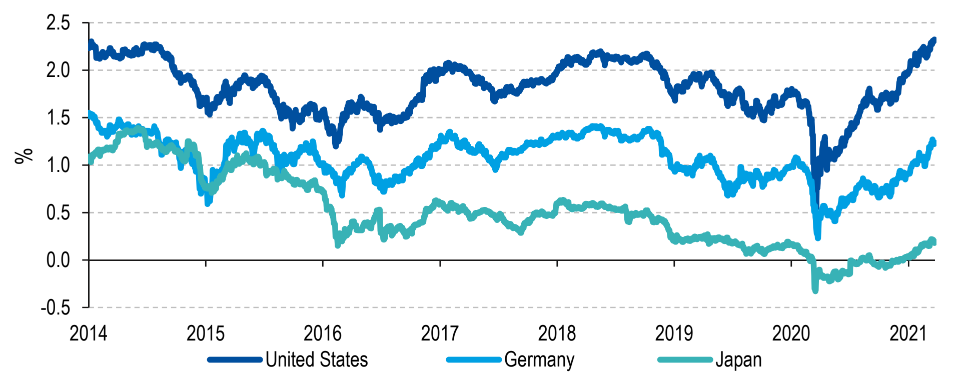
EM bonds

The higher rates prospects in the US are weighing on EM in the near term. On HY, we are more defensive now as we believe spreads may widen from current levels. LC debt also appears vulnerable at this stage, considering the FX risks. From a regional view, we are selective and active in frontier markets, and recommend investors cautiously increase exposure to oil exporters (rising prices, supply concerns, demand recovery).

FX

We have upgraded USD, with a near-term view, due to strong US growth projections. The rate differential in favour of the US vs. Europe explains our defensive stance on the Euro.

10Y breakeven inflation rates



Source: Amundi, Bloomberg, as of 18 March 2021.

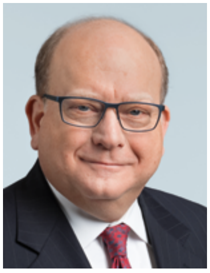
GFI= Global Fixed Income, GEMs/EM FX = Global emerging markets foreign exchange, HY = High yield, IG = Investment grade, EUR = Euro, UST = US Treasuries, RMBS = Residential mortgage-backed securities, ABS = Asset-backed securities, HC = Hard currency, LC = Local currency, CRE = Commercial real estate, CEE = Central and Eastern Europe, JBGs = Japanese government bonds, EZ = Eurozone. BoP = Balance of Payments.

EQUITY

A cocktail of rotation, selection and earnings growth

Kasper ELMGREEN,
Head of Equities

Yerlan SYZDYKOV,
Global Head of Emerging Markets



Kenneth J. TAUBES,
CIO of US Investment Management

Despite vaccination delays in Europe, we believe demand and earnings will surprise on the upside this year. but investors should not lose focus on the fundamentals

Overall assessment

A key topic for investors is whether companies will be able to pass on the increase in input prices and rising supply costs to consumers. If that happens, and we think it could, earnings growth should improve, driving rotation opportunities and equity performance going forward. Nonetheless, the recent volatility is an apt reminder that this recovery will be uneven and non-linear across sectors and regions. It also serves as a way of clearing excess froth in overexuberant segments of the market. Therefore, **investors should focus on fundamentals, the inherent strengths of business models and balance sheets.**

European equities

The 'great rotation', favouring cyclicals vs. defensives and value vs. growth, is demonstrating resilience. **But the focus now will be on economic reopening, interest rates and nervousness around overvalued hyper growth stocks**. As a result, we continue to look for businesses with strong balance sheets. We also believe investors should explore quality cyclical stocks in financials and materials. On the former, banks represent a sector where the recovery is not yet fully priced in, but selectivity is key. At the other end, investors should look for attractive defensive stocks in telecoms and consumer staples, which is anti-consensual and presents opportunities given the relatively attractive valuations. Remaining valuation-conscious is important due to the abundant liquidity that is finding its way through to different assets. Finally, amid the risks of rising rates – being monitored closely – unexpected tapering, ineffective vaccines against variants and/or delays in inoculation programmes remain key. **Any volatility among high-quality names may be an opportunity.**

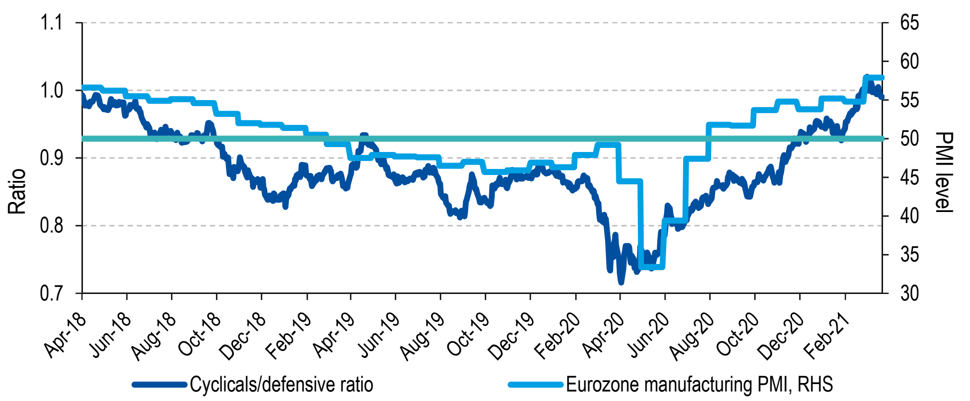
US equities

Pent-up consumer demand and supportive policies allow us to remain constructive, **especially on the high-quality cyclical value segments**, as they could benefit from a wide valuation gap with growth and a steepening of the yield curve. However, we may see some overheating of the economy amid supply bottlenecks and as Biden's stimulus seeps through. In addition, some caution is required on account of the expensive corners of the markets such as high-growth and momentum. Hence, we are selective and see more of a rotation rather than a correction. **Secondly**, **high-quality cyclicals, value and reasonably-priced growth stocks should benefit from earnings** improvements, in line with the economy. At a sector level, there are opportunities in financials, energy and even consumer names directly impaired by the Covid-19 crisis. Based on a global recovery and higher rates, companies in these sectors, especially those with sustainable business models and where the recovery is not yet fully priced in, should now do well. Longer term, we see some risks that could be handled by staying active. These include the fiscal stimulus being too large and the Fed potentially being forced to change its dovish stance sooner.

EM equities

We maintain a constructive view in light of improving EM and global growth prospects, but acknowledge the higher US rates. While we are positive on tech and internet, we think valuations in some areas are high. On the other hand, we remain cautious in consumer staples and healthcare, but have slightly upgraded our view of the latter. Our focus remains on stock selection as we continue to explore value names with cyclical growth and quality characteristics. As a result, we believe select financials names in Taiwan look attractive.

Rebound in manufacturing could support cyclical stocks in Europe



Source: Amundi, Bloomberg, data as of 17 March 2021. Stoxx Europe 600 Optimised Cyclical and Defensive Price indices

THEMATIC GLOBAL VIEWS

You asked, we answered

Our Global Views team attempts to answer some of the questions often asked by our clients

Didier BOROWSKI,
Head of Global Views

Pierre BLANCHET,
Head of Investment Intelligence

Tristan PERRIER,
Global Views

What are the next steps for the NGEU?

The *Next Generation EU* fund was agreed in July 2020 after weeks of acrimonious negotiations between EU member states which pitted the "frugal four" against the rest of the union. **The €750bn plan, comprising €390bn in grants and €360bn** in loans to member states, is actually built around a newly created €672.5bn instrument known as the Recovery and Resilience Facility (RRF), which was fully adopted by the European Council on 11 February 2021.

EU countries have until 30 April 2021 to submit their national recovery and resilience plans. They also need to set out their reform and investment agendas for the next five years. This can be an issue for countries, which are struggling to implement structural reforms and/or have upcoming elections, as is the case in France and Italy. Then, the EC will have up to two months to assess each plan, following which the Council will have four weeks to approve them. Grants and loans are given according to achievements and agreed milestones. Assuming that the ratification process is completed by 1 May, member states should receive the first funding by 1 August.

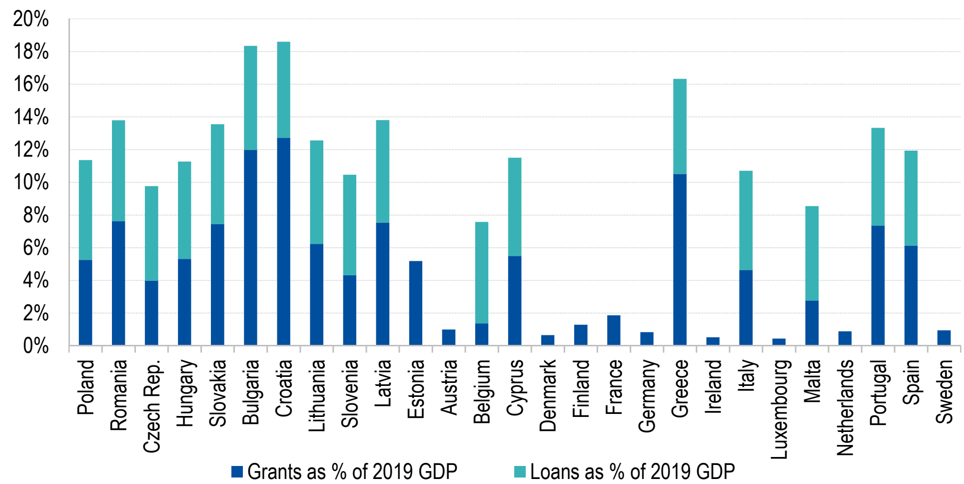
70% of the RFF's grants (€312.5bn) will be committed in 2021 and 2022, based on the unemployment rate in 2015-2019, inverse GDP per capita and population share. The remaining 30% will be fully committed by the end of 2023, based on the same criteria plus the drop in real GDP.

Several member states have started the ratification process ahead of the Council decision. At the time of writing, 11 out of 27 members have ratified the NGEU, with those 11 roughly divided between northern and southern states. The slow process is due to national parliamentary agendas and legal constraints, although so far it remains in line with EU budget timeline.

The European Commission (EC) is expecting to launch the fund and provide initial financing over the summer. However, the German ratification has been jeopardised by the Constitutional Court ruling on 26 March. The bill was passed by both the Bundestag and Bundesrat, and was about to be signed by President Steinmeier, but an appeal was made by a group of Eurosceptics. The Karlsruhe judges need to decide whether the "new own resources" i.e. taxes the Commission will create to finance the NGEU, are aligned with EU Treaties. The plaintiffs are not opposing the recovery fund *per se* but the fact that the new resources and debt issued are *de facto* leading to a fiscal union which violates the German constitution.

The plan has strong political backing in Berlin and should eventually be approved. Yet, the EC cannot raise money for the fund before all countries have ratified the NGEU, and therefore distribute 13% of the total amount in H2 2021 as planned. European economies need that funding as business activities are suffering from lockdown measures and low vaccination rates. We believe the pressure on politicians and judges will be significant enough over the coming weeks for the NGEU approval process to go through, and the first projects to be funded by September.

1/ **NGEU grants and loans**



Source: Bruegel Institute estimates, Amundi Research - Data as of March 2021

THEMATIC GLOBAL VIEWS

Towards a mini boom in the US in 2H21

Key agenda this year

- 30th April : member states need to submit their national recovery and resilience plans setting out their reform and investment agendas until 2026
- End June: The Commission will have up to two months to assess the plan
- 1st August: the Council has four weeks to adopt its decision on the final approval of each plan and send the funds to member states (first 13%)

Toward the creation of bad banks in Europe?

Given the public support measures, the Covid-19 crisis has not resulted in a significant increase in outstanding Non-Performing Loans (NPLs). European banks are well capitalised and there is no need to worry if an economic rebound materialises this year. It is worth remembering that it took until 2019 for European banks to return to their pre-2008 crisis NPL levels. The total amount of NPLs carried by European banks is currently around €600bn (the average NPL ratio, at 2.8% in Q3 2020, is low but there are significant differences between countries). Looking ahead, banks may need direct public support to ensure that increased NPLs do not limit bank-lending volumes.

The good news is that the European authorities have a clear strategy to remove NPLs from bank balance sheets in order to preserve the distribution of credit and **protect banks from a deteriorating economic situation**. The European Commission and the ECB have finally converged. The creation of a single European "bad bank" was initially preferred by the ECB but this is not the solution that is now envisaged. Indeed, the European Commission supports the creation of national "bad banks" that would instead be called Asset Management Companies (AMCs) to facilitate the management of NPLs. This network of AMCs would securitise and sell NPLs to final investors. **This is a key milestone that should increase the eurozone's resilience to external shocks.**

What are the impacts of the US vs. eurozone growth differential?

One year after the start of the crisis, we can assessment of the impact of the Covid-19 crisis. As far as the victims are concerned, the US has suffered a greater disaster than the eurozone (543,000 deaths vs. 445,000) despite having a slightly smaller population (330 vs. 342 million). This is due to the less restrictive measures imposed in the US. As a result, real GDP fell less in the US than in the eurozone last year (-3.5% vs. -6.8%). Given the new set of restrictive measures put in place in Europe, GDP growth may remain sluggish in Q2, while US economic activity will continue to expand at a brisk pace. It is therefore clear that the US is doing better than the eurozone from an economic standpoint. In recent months, the consensus has been continuously revised upwards in the US and downwards in the eurozone. As a result, it is now estimated that real GDP will return to its pre-crisis level by this summer in the US, but not before the end of 2022 or even the beginning of 2023 in the eurozone. This means that there is a 12- to 18-month cycle gap between the US and the eurozone.

The consequences for US interest rates are important. Firstly, because it reinforces the idea that inflation will materialise in the US first. However, in the wake of its strategy review adopted last year (the objective is now to raise inflation to an average of 2% over a cycle), the Federal Reserve (Fed) has time before it will need to hike rates, even if inflation surprises on the upside. We do not expect the first rate hike before 2023.

The USD 1.9 trillion (9% of GDP) fiscal stimulus package adopted by Congress will likely trigger a mini boom in 2H 2021. Even more so as a plan for some USD 2 trillion in infrastructure investment is likely to follow by year end. The Fed has committed to keeping its key rates unchanged in the short term, but not long-term interest rates. Its purchases of Treasuries (currently USD 80bn per month) have not been enough to prevent the rise in long-term bond yields (1.7% for the ten-year), driven by both real interest rates and inflation expectations. For the time being, there is no question of the Fed tapering its asset purchases, but eventually it will have to reduce its degree of monetary accommodation as the output gap closes. This decision would inevitably push US long-term interest rates higher.

In contrast, the ECB will oppose a movement on long-term interest rates should it be disconnected from eurozone fundamentals. The economy is too fragile, credit conditions need to remain easy, and some ECB members thus believe that further steepening of the yield curve would be premature. Inflation is still far from threatening the area and the fragmentation between core and periphery is still too large. It is therefore too early for the ECB to reduce the size of its APP.

The rise in US yields will be capped. In an environment of low interest rates, the rise in long-term rates in the US would eventually lead to a renewed appetite for US Treasuries from both domestic and foreign investors searching for yield. This would limit the rise in US long-term interest rates and may as a result temporarily strengthen the dollar against the euro.

However, the cycle gap will not continuously widen in favour of the US over the next 12 months, quite the

THEMATIC GLOBAL VIEWS

contrary. On the one hand, growth in the eurozone is expected to accelerate strongly in the coming quarters, while on the other, overheating in the US could lead to a boom/bust cycle, with growth falling back abruptly in 2022-23 as the effects of the fiscal stimulus fade away.

The European equity markets could benefit both from a positive trend in profits on the back of the recovery of the global cycle and prolonged accommodative monetary conditions should support valuations. The overrepresentation of technology stocks on the American market, which are sensitive to the rise in long rates, is causing a rotation in favour of cyclical and financial sectors which are more represented in European indices. This configuration of desynchronised growth should paradoxically benefit European markets, which offer a more limited risk of loss on sovereign and corporate bonds and a more attractive equity risk premium.

The case for a larger stimulus in Europe is likely to build

Should we expect further stimulus in Europe?

The short answer is yes, both regarding **fiscal support during the crisis and recovery stimulus after the crisis**.

Regarding short-term fiscal support, the slow start to the European vaccination campaign means that the reopening of closed sectors seems, as of today, a more distant prospect than in the US or UK. Governments will therefore need to continue the same kind of support measures that have been used extensively since the beginning of the crisis (mostly support for short-time work schemes, specific aid for hard-hit sectors and public guarantees on corporate debt), at a higher fiscal cost than forecast at the end of 2020. Germany, in particular, announced in March a debt-financed supplementary budget of €60bn that could increase its net borrowing to a record high of €240bn in 2021 (7% of GDP), although whether all this extra capacity will be used is highly contingent on future Covid developments.

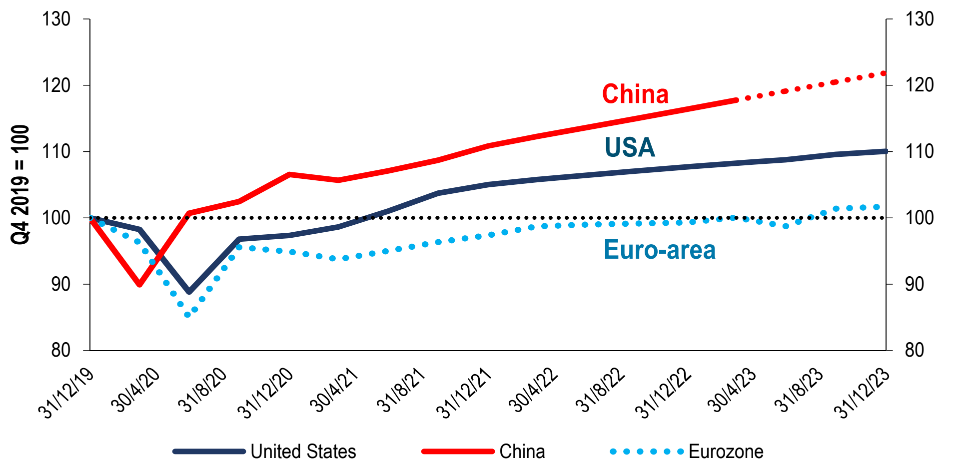
Recovery stimulus pursues a different logic. It can only be fully deployed once the economy re-opens, with plans mostly (although not entirely) focusing on investment rather than income support to households and life support to corporations. In this respect, the *Next Generation EU* (NGEU) recovery fund, that will be available from H2 2021 on, will be an essential tool, supplemented by efforts at the national level in the countries that have the capacity to do so. As the crisis has lasted longer than initially forecast, the residual damage that will need to be repaired after closed sectors are allowed to reopen will also be greater. The case for a larger stimulus is therefore likely to build. While it may be politically difficult to extend the NGEU (which was only agreed after tense negotiations in July 2020), greater efforts can probably be made at the national level, thanks to a prolonged waiver of EU budget rules. Note that prominent decision-makers (President Macron of France and ECB Board Member Isabel Schnabel) have recently called for more European-level fiscal stimulus.

What is America's new geopolitical agenda?

Anthony Blinken's very first foreign policy speech was quite insightful. The new administration aims to tackle the climate crisis and drive a green energy revolution, secure US leadership in technology, and last *but not least* manage its relationship with China, a relationship that has been called *"the biggest geopolitical test of the 21st century"*.

Trump's unilateralism is certainly over, and Biden's United States is based on a foundation of values and objectives shared with Europe (building a more inclusive economy, fighting global warming, consolidating democracies, fighting racism and inequality, etc.). But the multilateralism

2/ **Path to recovery post Covid-19**



Source: Amundi Research - Data as of 31 March 2021

THEMATIC
GLOBAL VIEWS

China real GDP per capita will double by 2035

advocated by Blinken is quite different from what Europeans have in mind. It is striking to observe that the European Union (EU) as a political entity is not mentioned once in this speech, while China is mentioned 17 times. And if Europe is mentioned at all, it is only once, and only in the same breath as the other continents, as the US wants to reinvent partnerships with its old allies (*"countries in Europe and Asia"*), as well as with its new partners *"in Africa, the Middle East and Latin America"*.

This obsession with China's rise corresponds to a tangible reality. It is estimated that China's real GDP will double by 2035, which roughly corresponds to a doubling of GDP per capita within 15 years. China is making no secret of its technology ambitions. **The US is seeking to maintain its dominance.** The EU is ultimately caught in a vice between the US and China.

For Blinken, artificial intelligence and quantum computing are the two pillars of tomorrow's technology. The technological competition between the two blocs has only just begun. It is no coincidence that this speech comes two days after the publication of the National Security Commission's report on artificial intelligence[1]. This report clearly aims to establish the way to maintain US leadership. It states that the US could lose its technological and military superiority to China over the next decade, something not seen since the end of WWII. The report therefore calls for a rapid fiscal effort of several hundred billion dollars to safeguard national security and US supremacy, without worrying about the resulting deficits. For example, in the context of a global semiconductor shortage, the report calls for the US to stay "two generations ahead" of China in semiconductor manufacturing and suggests significant tax credits.

Ursula von der Leyen's EU is certainly not to be outdone, claiming that Europeans are ready to assume and strengthen their power. The EU has just announced that it wants to double its semiconductor production by 2030 to 20% of world production. The concepts of strategic autonomy and European sovereignty are increasingly being put forward. However, they are not precisely defined, and their use is still controversial. On the economic front, the NGEU recovery fund adopted last year will certainly make it possible to deploy investments in key areas. But any delay in the start-up of the fund would have serious consequences.

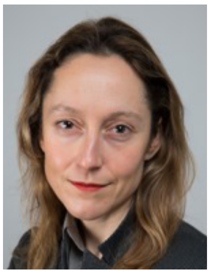
A tactical alliance between China and Russia on the one hand, **and the US and Europe** on the other, seems to be emerging, particularly with regard to democracy and human rights. But when it comes to economics, all blocs have divergent interests and will compete.

Finalised on 31 March 2021

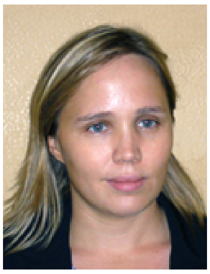
[1] *See www.nscai.gov*

THIS MONTH'S TOPIC

Fixed-income markets: from cyclical to structural challenges



Valentine AINOUZ,
Deputy Head of Developed Markets Strategy Research



Delphine GEORGES,
Senior Fixed Income Research Strategist

Since the start of the year, bond yields have surged in the economies of the G10 as markets anticipate a sharp acceleration in inflation and economic activity. This rebound is likely to be particularly strong in the US given its enormous fiscal stimulus plan. In the medium term, opinion is divided concerning the post-Covid crisis macroeconomic trajectory and a possible change in the inflation regime in the US.

During the last quarter, US 10-year yields reached the milestone rate of 1.6%, dragging in their wake German 10-year rates, which rose by 22bp to -0.35%. These figures reflect greater investor confidence in the growth outlook for the US economy. Given the extent of the fiscal stimulus programme, we now expect growth in the US to reach nearly 8% in 2021 and 4% in 2022, with inflationary pressure remaining contained. The situation is different in the Eurozone, which should take longer to return to pre-Covid growth trends. Ultimately, the rise in bond yields does not put the same pressure on the Fed and the ECB.

The Fed will support economic recovery in the US by tolerating higher inflation

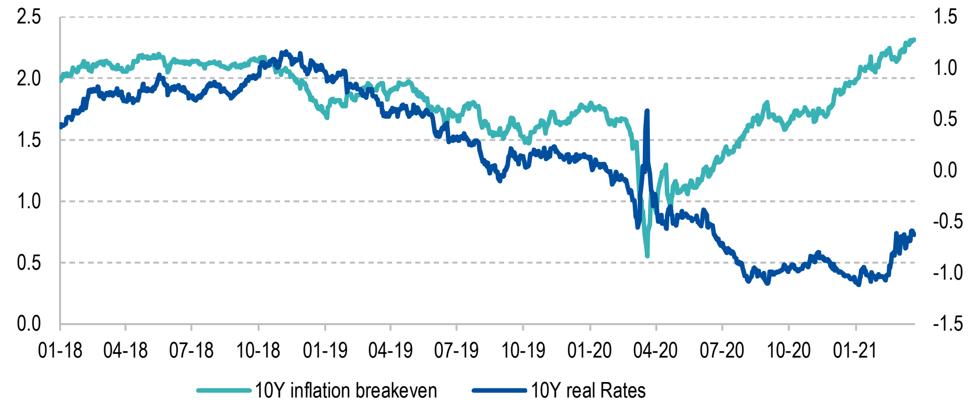
The members of the Fed were not unduly concerned about the recent rise in yields. Long-term real yields, which were at excessively depressed levels at the end of the year have returned to more normal levels, while the long-term inflation breakevens are approaching levels more consistent with a Fed successful in achieving its symmetric 2% inflation target. In J. Powell's latest speech, he gave no indication that the Fed would seek to contain this recent rise in yields. On the contrary, the Fed embraced the notion of rising yields because of an improvement in the growth outlook. Important point: financial conditions remain very accommodative.

At the same time, the Fed will not act pre-emptively: J. Powell said they would not act pre-emptively based on forecasts but would rather wait to see actual data, and that it would take people time to adjust to that new practice. J. Powell therefore kept a prudent tone and recommended patience concerning any change in monetary policy. He said it would take some time for substantial progress to be seen and that it would also take some time for unemployment to go down. Nevertheless, a notable change was evident in the Fed Chairman's discourse: J. Powell clarified that an increase in rates would be possible under certain conditions: (1) maximum employment, (2) inflation reaching and staying at 2%, and (3) inflation increasing moderately above 2% for a certain length of time. This differs significantly from the previous message that they envisaged no rate hike.

The FOMC expects no fed funds rate hike before 2024 (median projections) despite the upward revision to economic growth, employment and inflation projections. Unemployment and the core PCE are expected at 3.5% and 2.1% respectively in 2023. The members of the FOMC stressed that uncertainty was still very high around the virus but also highlighted the nature of the recovery and the extent of fiscal support. The Fed does not fear an overheating: inflation should remain slightly above 2% over the coming years (core PCE at 2.2% in 2020, 2.0% in 2021 and 2.1% in 2022). In this context, only 7 of the 18 members of the FOMC expect a rate hike before 2024 (4 in 2022 and 3 in 2023).

The Fed is now officially behind the curve

1/ **The upward move in nominal yields has been driven recently by an increase in real yields**



Source: Bloomberg, Amundi Research, Data as 22 March 2021

THIS MONTH'S TOPIC

The Fed believed that a rise in inflation would be neither particularly large nor persistent

The ECB is preoccupied by the recent rise in yields

The members of the Governing Council remain prudent given the recent rise in bond yields. The ECB has clearly stated a preference for keeping low levels of nominal/ real yields and relatively flat curves.

- Christine Lagarde said that the ECB was closely monitoring the evolution of longer-term yields.
- Isabelle Schnabel added that "a too abrupt increase in real interest rates on the back of improving global growth prospects could jeopardise the economic recovery".
- Fabio Panetta pointed out that we are already witnessing unwelcome contagion from the rise in US yields which is incompatible with the outlook and negative for the recovery.

In fact, the European economy will take longer than the US economy to return to its pre-Covid growth trends. The economic gap between the United States and the Eurozone is expected to widen: (1) the United States entered the Covid crisis with a much stronger economy (2) the pandemic has more strongly affected the euro zone (3) fiscal support is much stronger in the United States.

Also, the Covid crisis has increased economic fragmentation within the Eurozone. Germany, Austria and the Netherlands have seen a less severe recession: more ambitious emergency and recovery plan, reduction in restrictions and less exposure to the tourism sector. Italy, Spain and France have been particularly badly hit by the crisis.

As long as economic fragmentation prevails in the Eurozone, the ECB must maintain a stable cost of financing of public debt. Fiscal policy can only be effective if sovereign yields remain low and stable even in the face of growing deficits. In the absence of a significant rise in growth expectations, the ECB stands alone in trying to avoid financial fragmentation. The ECB's capacity to convince the market through its communication and action of its ability to control interest rates will be decisive for peripheral yields and credit spreads. After the acceleration in the pace of purchases under its emergency program, we expect the ECB to increase the size of the programme.

The upward pressure on bond yields led by US treasuries remains therefore a threat for the Eurozone. The ECB will have to manage the economic divergence between the US and the Eurozone over the coming months. Moreover, If there is any change in the inflation regime in the US, it would pose a real challenge for the European Central Bank and the Eurozone economy.

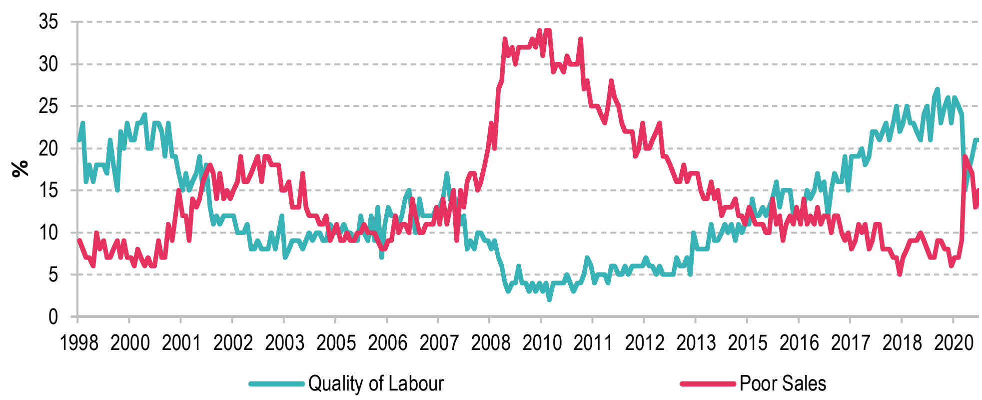
Will we emerge from the Covid crisis with a fundamentally different macroeconomic trajectory from that which we were in at the start of the crisis?

We do not think that the pent-up demand from the pandemic and the $1.9tr government stimulus will reverse the forces that have driven interest rates down over the last decade. Moreover, US reflation trade cannot go too far too fast. High asset prices and high debt levels make growth fragile. The recovery is conditional on stable asset prices (real estate, corporate debt, equity). There is much more sensitivity to underlying movements in rates.

However, a new trajectory of inflation is possible because structural changes can be put in place.

1. **The Fed is willing to let the economy run hot.** The section of the economy not directly affected by Covid performed well during the crisis. Thanks to the Fed, the cost of corporate debt has fallen massively. Well-capitalised companies benefit from an incredibly low level of interest rates for their development:

2/ **Difficulties in finding qualified workers is not far from pre-crisis levels**



Source: Bloomberg, NFIB survey, Amundi Research, Data as of 28 February 2021

THIS MONTH'S TOPIC

The ingredients are in place to see a structural change in the inflation regime in the United States

M&A activity remains very strong, driven by the consumer non-cyclical, tech and communication sectors. Highly leveraged companies also have the opportunity to significantly reduce the cost of their debt. Indeed, activity on the HY primary market for refinancing purposes is very strong. Consequently, on the labour market the context is very different from 2008. Small businesses are struggling to hire qualified workers, despite high unemployment.

2. **The Biden administration is committed to increasing potential growth through an infrastructure plan and a reduction of social inequalities.** Wage growth in the last decade has been uneven, with notable growth only at the top while wages for most workers have failed to rise. Moreover, this crisis has raised social inequalities to barely sustainable levels, mainly affecting low-paid and low-skilled workers. Today, 40% of the jobless population are long-term unemployed.
3. **The cost of supply is rising.** Raw material inflation has picked up, mostly for Covid reasons. However, the long-term supply cost could also be on the rise (significant raw material needs due to infrastructure plans, relocation, environmental costs). In this context, it is time to pay attention to pricing power within sectors.

The already sharp repricing in long-term global yields will continue driven by a strong acceleration in the global recovery over the next quarters. The rise in yields will be driven by breakevens and real rates, which both retain upside potential as the recovery progresses. Thanks to continued support from the ECB, we expect a very modest rise in German bund yields and we are maintaining our positive positions on peripherals. **We expect 10Y UST-Bund spreads to continue to widen. We need to closely monitor the risk of rising inflation in the United States**.

Finalised on 24 March 2021

THEMATIC

Speculative grade default cycle: an earlier peak and an expected benign trend

Sergio BERTONCINI,
Senior Fixed Income Research Strategist

Extraordinary policy intervention has made this HY default cycle unusually short-lived, helping to limit quite significantly the rise in defaults among mid- and high-rated speculative grade companies. A turn into a more benign falling trend over the next quarters looks likely, in light of improved macro perspectives, expected progress in vaccinations and encouraging signals from financial drivers.

A short-lived, quite unique cycle

The current cycle has recorded a very rapid rise in default rates, driven by the credit effects of the coronavirus-induced recession and the stress already prevailing in some sectors like energy and retail, especially in the US before the crisis. After being quite low by historical standards for a long period, the global default rate of speculative grade companies rose rapidly to its highest levels in the past decade, **doubling in just a few months to 6.6% from its 3.3% level of February 2020**. The initial shock to economic activity and to financial market conditions, though the latter was only short-lived, led credit events to move rapidly between March and the summer. Accordingly, **US default rates** immediately **moved higher from the 4% area, rapidly reaching 9% in the summer**. **European default rates were more resilient in the first months of the crisis**, also thanks to much lower exposure to the energy sector and higher average credit quality, **but then to some extent they closed the gap partially with the US, moving from a 2% starting level to 5% in autumn**.

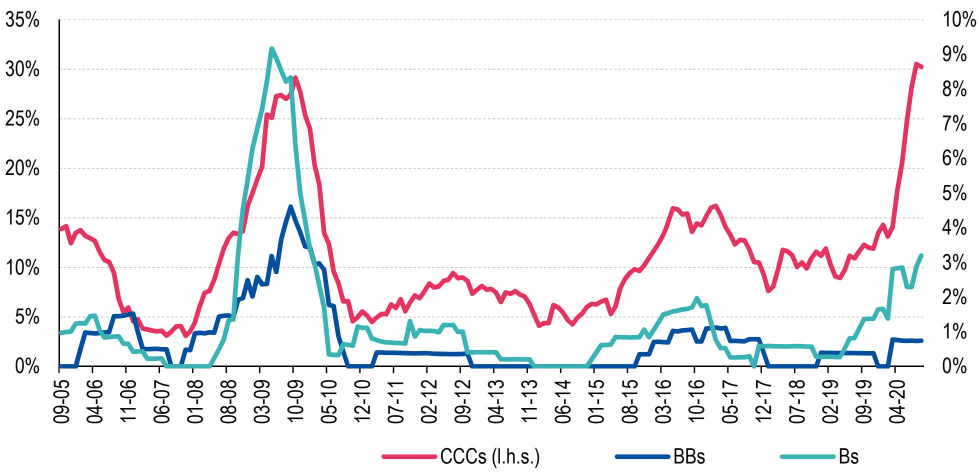
As we highlighted in previous focuses, the main drivers of the upward trend were **US companies** in the **energy sector**, challenged by depressed oil prices, which created a tough operating environment within the Oil & Gas sector, especially in the Exploration & Production and Oilfield Service subsectors. The other two sectors accounting for a large proportion of defaults in the US, and struggling more than others with pandemic-related business disruption, were Retail and Business Services.

In terms of **credit quality affected**, an analysis of the defaults rating breakdown probably shows the most striking divergence with previous experiences. Even at the time of writing, which is already seeing the start of a downward trend in bankruptcies, the cycle still looks **almost entirely a CCC-rated story**, as high and mid-rated companies still show very few defaults, close to historically low levels. Interestingly, as chart 1) shows, current BB-rated and single B-rated default rates are still quite low by historical standards for a recession, even more if we account for the severity of the 2020 contraction. In a nutshell, the chart shows that both rating categories peaked in terms of defaults at less than one third of the usual recession-high levels. On the contrary, most vulnerable and less "policy-supported" CCC-rated default rates have rapidly jumped to the highest levels of the GFC, namely in the 30% area.

Another peculiar feature of this default cycle is its limited length, made quite short-lived by unprecedented interventions of both fiscal and monetary policies through a very prompt deployment of huge stimulus, ultimately preventing a credit

Rating agencies have progressively cut their forecasts on projected defaults

1/ **US HY default rates, by rating**



Source: BofA ML, Amundi Research - Data as of March 2021

THEMATIC

crunch to materialize and lowering even more financing cost. For the first time in a crisis, furthermore, a strong increase in refinancing activity made default rates a lowest rating/sector story. In fact, the Fed was quite effective in keeping defaults from rising through its unprecedented active approach, entering corporate purchases for the first time, and even moving in support of fallen angels. In Europe, the combination of unprecedented fiscal measures, especially through state guarantees, and all of the liquidity measures put in place by the ECB on the monetary policy side (through TLTROs initially) also proved to be quite effective in avoiding the credit crunch risk on bank loans, the key funding channel for European companies. The latter relied quite heavily on bank loan facilities and did not need to tap the bond markets for substantial refinancing and to build cash buffers. Finally, the low-yield environment tempered defaults, too, especially among high- and mid-rated companies. With respect to the severity of GDP contraction, then, the level of the default peak looks quite low, too.

From this respect, we stress that in the past two quarters **rating agencies have progressively cut their forecasts on of projected defaults**, especially in the US, where they were higher between March and the summer. Furthermore, the duration of the cycle has been shortened, as the peak until a few months ago was still projected for the end of Q1 2021, one year since the start of the crisis. Recently, on the back of better than expected year-to-date trends and improved macro perspective, Moody's revised down its 12-month estimates, indicating as well an earlier peak in the cycle, which likely is already behind us. According to its latest projections published in the March default report, the rating agency now expects US HY and European default rates to fall, respectively, to 4.9% and to 2.8% by February 2022. The gap between the two areas should therefore remain in favour of Europe, albeit to a lesser extent than in past months. Moreover, in terms of sectoral drivers, the impact is going to turn from previous trends, as Hotel, Gaming & Leisure is expected to be among the most impacted sectors on a one-year timeframe in both advanced areas.

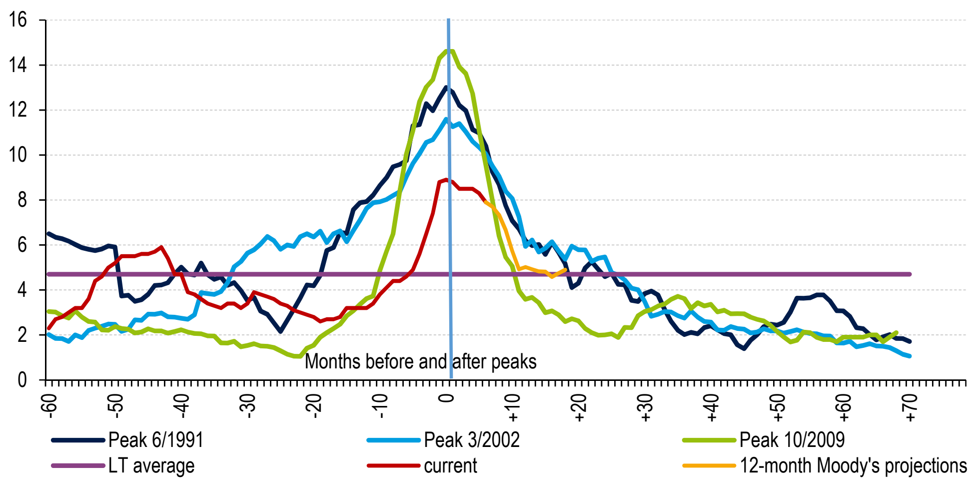
Although recent volatility has led long-term yields higher, the overall cost of financing remains close to historical lows for speculative grade companies

2021 starting trends and forward-looking indications from financial drivers of defaults

Global defaults fell in February, with the global 12-month speculative grade default rate standing at 6.6%. US HY defaults moved down to 7.9%, from 8.4% in December, while European defaults decreased slightly to 4.7%. The most active period in terms of defaults was from April to July 2020, with a monthly average of 28 global corporate debt issuer defaults. Since then, the pace has lost momentum, with the number of defaults dropping to 13 in August and September and remaining relatively stable by the end of the year. In January and February, the trend moved further down. The decline in the number of defaults that took place mainly in the US was supported by the macro recovery, persistent easy financial conditions and the very low cost of funding. According to Moody's, in fact, Europe recorded just one default in the first two months of 2021, while four US companies defaulted over the same period. Recent months showing improving trends in global trends did not change either the composition of defaults by rating or the high concentration in low-rated names we reported earlier. Assuming a downward trend in defaults over the next year, that would mean that one of the most peculiar features of this cycle on different impacts by rating category would be confirmed.

Among financial drivers of defaults that we monitor closely, distress ratios (or the percentage of bonds trading at or above 1,000 bp spreads) had already fallen rapidly

2/ US HY current default cycle vs previous



Source: Moody's, Amundi Research - Data as of March 2021

THEMATIC

and remarkably from their March peaks (above 30), sharply declining in December last year at 5.4% and 5.1%, respectively, in the US and Europe. By the end of February, these ratios had fallen further into the 3% area, reinforcing the likelihood of a low default rate environment one year from now.

Different signals came from **surveys on bank lending standards** in US and Europe: thanks to combined ECB huge liquidity injection and the ample usage of government guarantees, EZ bank lending standards remained substantially stable and close to pre-Covid levels in the first months of the crisis, until the past two quarterly readings. On the contrary, bank lending standards tightened considerably in the US in the aftermath of the crisis, with a subsequent more limited activity in leverage loan market, compared with bond market issuance. However, the very last quarterly readings have shown quite a decisive reversal, with the gap between the two areas compressing and recently turning, as European banks moved to tighter standards, while US banks retraced from tighter peaks. The very last survey recently published by the ECB pointed to a further tightening in the Eurozone, confirming a first move higher in Q3 survey, albeit with quite some differences among countries.

Interestingly, **the tightening in EZ standards affected more SMEs** in Q4, with the net percentage of banks tightening rising from 19% to 25%, while the same percentage remained stable and lower for large companies, at 16% in Q4, too. The opposite was the case for **US banks**, which saw quite a fall in the net percentage of banks tightening lending standards in the latest Fed survey, namely from 37% to 5%. The improved picture for US economy is likely behind this recent change in banks' stance towards loan standards in the US.

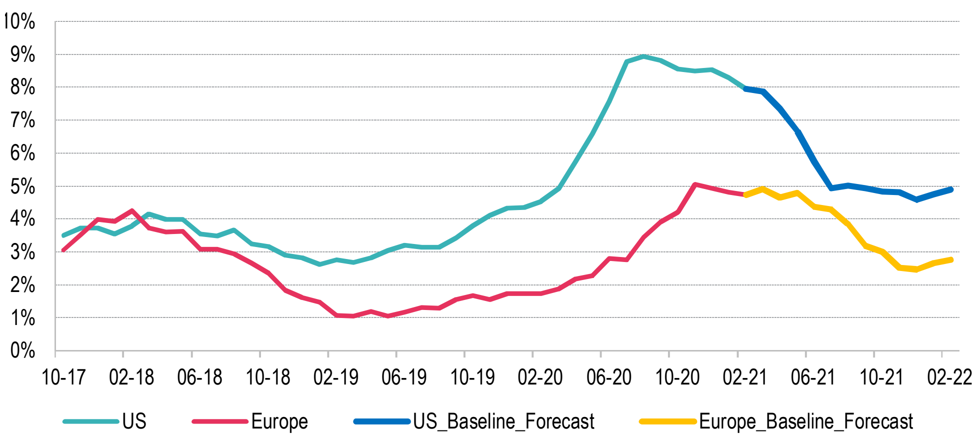
The March TLTRO auction was quite successful, with a high overall take-up above consensus, indirectly sending an encouraging signal for credit trends and future readings of lending standards. An improving macro picture expected in H2 this year and in 2022 should limit the potential for further tightening in lending standards, even though government guarantees will later fade, and contribute to stabilising the trend in the last two quarters.

Conclusions

Extraordinary fiscal and monetary intervention has made this cycle unusually short-lived, contributing to compressing the extent of rise in defaults and limiting quite significantly its negative impact on mid- and high-rated speculative grade. A turn into a more benign falling trend over the next quarters looks sustained by both improved macro perspectives on the back of further fiscal stimulus recently approved and ongoing expected progress in vaccinations, and by encouraging signals coming from financial drivers. Although recent volatility in bond markets has led long-term yields higher, the overall cost of financing remains close to historical lows for speculative grade companies, as monetary policy stances continues to anchor short-term rates at low levels in advanced economies, indirectly making spreads relatively resilient to the steepening of yield curves. We expect, as well, central banks to keep preserving easy financial conditions for the time needed to for the recovery to gain ground and move back to pre-Covid levels, ultimately indirectly supporting an improved picture for credit metrics on the fundamental side. At the same time, the specific and global challenges for company leverage caused by the crisis and the time needed to recover in some sectors maintains the preference for high quality and a focus on selection that will make all the difference during the recovery phase, too.

Finalised on 19 March 2021

3/ **HY Default rates**



Source: Moody's, Amundi Research, Data as of March 2021

THEMATIC

Bastien DRUT,
Chief Thematic Macro Strategist at CPR AM

With the contribution of:
Inès BELHAJJAM,
Strategist

Next step for the Biden administration: the infrastructure package

While the Biden administration has just successfully passed a $1900 bn stimulus package, attention will now turn to the infrastructure package that was included in Biden's campaign promises.

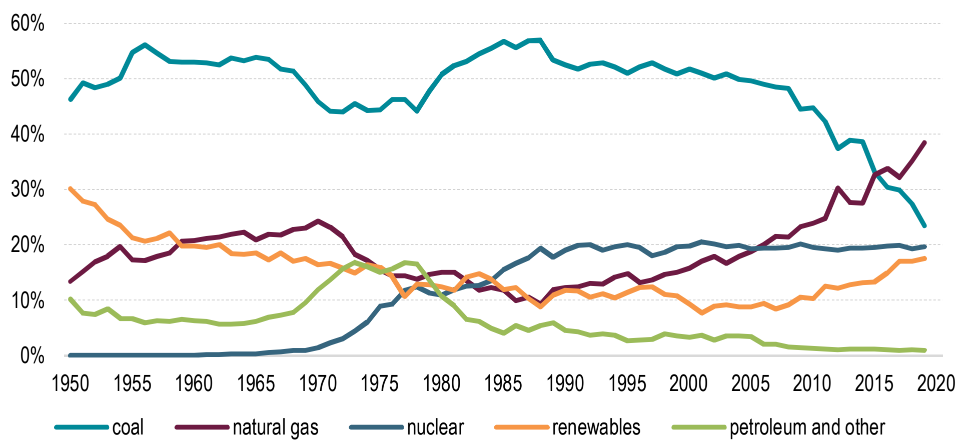
Infrastructure needs in the United States are urgent, and huge investments must be made if the administration is to meet its climate objectives. In 2017, public spending on infrastructure in the US was 2.3% of GDP, the lowest since World War II. Many infrastructures have not been renovated for decades, and the average age of the nation's infrastructure continues to rise. This year, the American Society of Civil Engineers gave a C- grade to US infrastructure and a D grade, that is to say in poor condition, to 11 of the 17 infrastructure categories assessed. In addition, climate change justifies the implementation of "green" investments, either to meet the Biden administration's climate goals (participation in the Paris Agreement and probable announcement of a carbon neutrality goal by 2050), or to make infrastructure more resilient to climate disasters.

The scope of the coming infrastructure package is not yet clearly defined. In July 2020, the House of Representatives passed the Moving Forward Act, a $1.5 trn bill focused on infrastructure, but the Senate, whose majority was Republican at the time, did not vote on it. This Moving Forward Act could clearly serve as a model for Biden's infrastructure plan, as its objective was to achieve "decarbonisation" of all types of infrastructures in the US. Projects included repairing roads and bridges, upgrading public transit systems and bringing internet access to rural and low-income communities. During his election campaign, Biden evoked a $2 trn "Build Back Better" plan, with a particular focus on green energy, but since then some have talked about $4 trn, as it might include a retraining section (job creations in clean energy sector, destructions in others). The cornerstone of the project would be to reach 100% carbon-free electricity generation from 2035. "Amtrak Joe" had also promised the second "Great Railway Revolution" with the electrification of the rail system and an extension of existing interstate rail lines.

But for several reasons, this is not as easy as it sounds. Weren't we already talking about a major infrastructure package under the Trump presidency? The complexity here is that public infrastructure is largely owned by local governments (states and cities). Less than 7% of public infrastructure was owned by the federal government in 2019 (1.1% of roads and highways, for example) and this share has decreased continuously since the Second World War (it was 17% in 1946). **Another hurdle is the highly polarised political class and the very thin Democratic majority in the Senate.** The recent past has shown that infrastructure bills could be drafted in a bipartisan way but still without getting enough support, like the America's Transportation Infrastructure Act on bridges and roads, which was drafted by both Republicans and Democrats, but never came to a vote. As there is still common ground on some topics, the key to the success of the infrastructure package may be… in its dismemberment into several separate small bills, rather than a very large one.

A hidden consequence of this package is that it could exacerbate inflationary pressure

1/ US: breakdown of electricity generation by major energy source



Source: CPR AM, EIA

THEMATIC

Another key hurdle is simply the funding of the package. It is rather clear that it will not be completely debt-financed and that it would lead to tax hikes. Several proposals were embedded in the Biden's agenda (corporate tax, tax hike for wealthy households) but here too, some levers unused for decades could be activated, like the federal gas tax (18.4 cents per gallon), which has not been changed since 1993. The CBO has proposed a tax hike of 15 cents per gallon, which would cause a 6% increase of gasoline prices. A carbon tax has also been mentioned. Thus, a hidden consequence of this package is that it could exacerbate inflationary pressure.

If the package is finally adopted, the market consequences might be dramatic, as Jerome Powell has underlined this type of stimulus, as opposed as relief measures, can lift potential growth... and, consequently, neutral rates.

Finalised on 19 March 2021

CENTRAL & ALTERNATIVE SCENARIOS

Monthly update

Significant progress in managing the pandemic, massive fiscal impulse in the US, and boosters in the RoW amidst accommodative monetary policies. All these call for a rebalancing of the probabilities assigned to our scenarios. We are raising the probability of our upside case from 10% to 20% and lowering the probability of our downside scenario from 15% to 10%. We have lowered the probability of our central scenario, which assumes improving growth and a contained inflation trajectory, from 75% to 70%. In this scenario, equities outperform on the back of abundant liquidity and improving fundamentals, while higher US bond yields and slow vaccine rollout in the EU pose tangible risks.

DOWNSIDE SCENARIO 10%

Stagflationary pressure

Analysis

- Genetic evolution of the virus leads to relapses in economic growth, and lockdown measures until 4Q21, prolonging the crisis
- Vaccine side-effects and/or lasting shortages undermine confidence and diminish global prospects
- The highly pro-cyclical US policy ends up destabilising inflation expectations and causes a rise in interest rates, the USD and/or commodities, which destabilises risky assets (volatility shock) and impairs financial stability. Tighter financial conditions exacerbate economic and financial fragilities
- Chinese growth slowdown spills over to DM economies
- Protectionism and de-globalisation accelerate, negatively affecting trade and global value chains

Market implications

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

CENTRAL SCENARIO 70%

Multi-speed recovery

Analysis

- Policy boosters allow a multi-speed recovery narrowing the growth premium gap between EMs and AEs
- Improving macro and micro fundamentals make financial markets resilient
- Massive vaccine rollouts in 1H21, though uneven across regions. Possible weakening in growth (until Q4 21) in some countries, due to delays in vaccination and/or new lockdowns
- Strong political commitment to mobilise fiscal policies in AEs, but timely execution in EZ is a risk
- Accommodative monetary and fiscal policies continue to support the recovery, keeping deflationary risks at bay and allowing debt/GDP ratios to stabilise
- Positive momentum in corporate earnings and reducing solvency risks
- The Covid crisis exacerbates income and wealth inequalities, thus increasing social and political tensions

Market implications

- Progressive rotation from Credit HY into equities, favouring value and cyclicals
- Contained steepening of US Treasuries yield curve spills over into EZ and EM.
- Maintain growth and income pockets with EM Equity and credit on rising earnings. Selective on EM HC.

UPSIDE SCENARIO 20%

Sustainable & inclusive recovery

Analysis

- Mass vaccinations resolve the public health crisis by the end of 1H21, eventually enabling a full global recovery in 2H21
- With less uncertainty, policy boosters feed through to the real economy and financial markets, closing the gap between manufacturing and service sectors
- Savings turn into consumption on increased disposable income, which allows a virtuous circle of growth/ inflation (no global overheating)
- Medium-term productivity gains from new digital and green developments
- Inclusive and sustainable growth diminishes the need for further policy support to reduce inequality gaps

Market implications

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

TOP RISKS

Monthly update

Risks are clustered to ease the detection of hedging strategies, but they are obviously linked. We have amended the overall narrative and change the probabilities of risks in light of recent developments and changes in our central & alternative scenarios.

ECONOMIC RISK 15%

- **Pandemic 2.0 with vaccine rollout issues**
  - Unexpected logistic issues or side-effects of the vaccine could have a very negative impact on investor and business sentiment
  - One or several virus variants that would make existing vaccines ineffective would undermine the economic recovery
- **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"**
  - Upward inflation pressures could build up, as the epidemic fades away
  - QE programmes may become problematic as inflation expectations rise
  - Inflation dynamics and central banks' reaction function could be sources of uncertainty, in particular in EM, where inflation is close to CBs' target
  - An early exit or miscommunication by the Federal Reserve could lead to a second taper tantrum similar to 2013

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

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

FINANCIAL RISK 20%

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

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

- **Oil, risky assets, frontier markets and EM**

(GEO)POLITICAL RISK 15%

- **US/China cold war**
  - Democrats maintain uncertainties regarding the relationship with China
  - Several sanctions and delisting of Chinese companies are signs of escalation
  - Possible accidental confrontations in the South China Sea or the Taiwan Strait, where Chinese aircraft are regularly making incursions
- **Instability within, and among, EM countries** on the back of chaotic virus crisis management and rising food prices
- **Post-Brexit risk of undermined European cohesion**
  - 2020 ended with an exit deal but implementation proves to be a lot more disruptive than expected
  - The City might lose market share faster than expected
  - The UK has to decide where to stand between the US and the EU, as well as China
  - UK exploiting the divergence and looking for competitive behaviour across the EU, which would potentially undermine EU cohesion

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

- **Oil, risky assets, EMBI**

CROSS ASSET DISPATCH: Detecting markets turning points

How to the read turning point assessment

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

ECONOMIC BACKDROP

- Economic activity 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 level remain evident, with the manufacturing sector outperforming services. Growth should progressively gain momentum from Q2 onwards as economies gradually reopen.
- Economic activity in the US is gradually gaining momentum with both high-frequency and soft data showing a sustained increase in private-sector business activity in the manufacturing and service sectors. The new fiscal stimulus will further support growth.
- A gradual reversal in economic surprises will likely continue as further upside surprises become increasingly difficult to materialise, as the consensus remains very high.

FUNDAMENTALS & VALUATION

- Current market levels already discount a significant part of the expected recovery in profits.
- Absolute PE levels are above historical trends despite growth remaining a solid argument for a temporary divergence from the historical average.
- After the recent spike in rates, the relative value metrics offer less support for markets to move significantly higher.

DEFENSIVE ASSET ALLOCATION

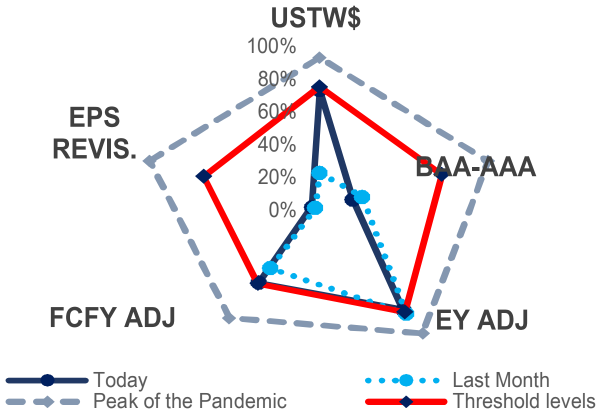
TECHNICALS

- Technicals remain mixed and challenging for the entire risky assets spectrum.
- While equities and HY still show a decent momentum score (signalling that investor appetite is still anchored to those assets), contrarian signals are flashing orange (i.e. neutral exposure).
- Our RSI-based signal looks less stretched now that markets are in a consolidation phase, yet we remain far from a green light.
- With rising interest rates weighing on multiples (which remain stretched and linked to the huge liquidity injected into the system) and no clear-cut directionality in many risky markets, we see technicals as neutral at present.

SENTIMENT

- Despite the recent turbulence, our risk sentiment metrics remain strong in all components
- The overall RISK OFF probability remains low and continues to suggest an overweight in risky assets.
- The repricing in nominal and real rates has been sharp and strong, yet our financial condition indices are firmly in easing territory across all of the main regions.
- The point of attention relates to the USD trend (if more pronounced and broad-based it would add pressure to our CAST) and the already visible consolidation in earnings revisions.
- The latter seems rational given the strong bounce back we had in H2 last year. It is something the market can possibly look through in the event of strong EPS results. While the peak in euphoria may be behind us, it is important to check closely whether a sharp mood inversion could occur.

Cross Asset Sentinels Thresholds (CAST) still supportive



Source: Amundi Research, Data as of 18 March 2021

CAST flags extremely low risk perception.

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

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

GLOBAL RESEARCH CLIPS

1 Growth narrative taking the lead corroborates the “risk-on” stance across assets

- In the US, significant progress in pandemic management, massive fiscal impulse and huge household savings are underpinning the growth dynamic and should lead to a DM economic recovery.
- We have revised our UST 10y 12-month yield range forecast to 1.8%-2% (from 1.5-1.8%).
- The Eurozone is lagging behind, as lockdown measures limit the recovery, and we expect a decoupling of US vs. Eurozone economic growth. The ECB will therefore maintain easy financial conditions.
- The rebound in Eurozone corporate earnings growth is not fully priced in by the markets, while interest rate expectations are unlikely to move higher. The value/cyclical features of EU equity markets confirms our preference for European equities.
- We expect the economic growth premium between EM and DM to narrow, suggesting a more cautious and country specific exposure to EM equities

2 Rates moving towards a higher regime as growth outlook materially improves: volatility and speed are a key risk, with global spillovers via tightening financial conditions

- The expected ranges call for a contained steepening in the UST 10-30 year section.
- As the long-end of the yield curve is already a source of risk for institutional investors’ P&L, we believe that the Fed will be vigilant and prevent a strong rise in UST 30y yields and avoid the negative snowballing effects across asset classes.
- The rise in 10y real yields will be nevertheless be limited by the FAIT (Federal Reserve Average Inflation Targeting) framework, which anchors 5Y real rates, as the Fed commits to raise rates only when Core PCE is sustainably above 2%
- The reaction of EM Fixed Income and FX to higher UST yields has been heterogeneous and smoothed by the broader “risk-on” environment
- The rebound in the US dollar and US interest rates are not yet sufficient to alter our broad preference for EM vs. DM.

3 USD: Short-term bull, medium-term dull

- The USD appreciated vs low-yielding FX, while commodity currencies are still outperforming the greenback.
- As US inflation expectations start to drift lower while real rates are holding up, we expect a strengthening of the USD trend vs the entire G10 spectrum.
- We have revised our EUR-USD targets accordingly: short-term to stay in the current (1.16 to 1.18), and returning to its depreciation trend in the medium term (towards 1.24)

4 Turkey: unexpected change at the CBRT

- After a few months of orthodox MP (+875bps of tightening since November 2020), the governor of the Central Bank of the Republic of Turkey (CBRT) was sacked the same week he raised the policy rates by 200bps to 19%.
- That decision has triggered some turmoil on the Turkish assets and a sudden repricing of MP expectations for the months to come. CBRT is now expected to cut its policy rates earlier and by more than expected. While inflation should moderate by the end of 2021, in the next months it is expected to climb up to 18% YoY.
- The market has considered the event an idiosyncratic incident with only a brief impact on EM asset classes.

Covid-19 situation update

by Pierre BLANCHET, *Head of Investment Intelligence*

Fifteen months after the virus left China, the WHO has registered 128 million confirmed cases and 2.8 million deaths. Nearly 80% of registered contaminations are in Europe and the Americas. Despite being the most populated continent, Asia has not recorded more than 15 million cases overall. Since there is still no treatment, mass vaccination to reach herd immunity and social restrictions are the only solutions available. A total of 520 million vaccine doses have been administered so far, with 140 million doses in the US alone.
The number of available vaccines is rising. Europe granted approval for the J&J vaccine in March. Novavax (US) and CureVac (Germany mRNA vaccine candidate) are in late-stage trials and may be approved in the coming weeks. Pharma companies distributing available vaccine are now working on boosters, next-gen vaccines and paediatric trials. The AstraZeneca/Oxford vaccine, mainly used in Europe, has been paused several times and its efficacy has been revised downward.
An effective therapy has yet to be found. GSK & Vir are trialling an antibody therapy, which is showing an 85% decline in hospitalisation or death vs a placebo.

Coronavirus Vaccine Tracker

PHASE 1	PHASE 2	PHASE 3	AUTHORIZED	APPROVED	ABANDONED
47	33	23	6	7	4
Vaccines testing safety and dosage	Vaccines in expanded safety trials	Vaccines in large-scale efficacy tests	Vaccines in early or limited use	Vaccines approved for full use	Vaccines abandoned after trials

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INVESTMENT STRATEGY

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