Institute

#12
December
2022

CROSS ASSET
Investment Strategy

CIO VIEWS

A relief rally, excess optimism overdone

AMUNDI INSTITUTE

Defensive asset allocation extends into 2023, with a gradual increase in risk exposure later in the year

Confidence must be earned
Amundi
ASSET MANAGEMENT

#12 - December 2022

Table of contents

CIO VIEWS

A relief rally, excess optimism overdone

Vincent MORTIER,
Group Chief Investment Officer

Matteo GERMANO,
Deputy Group Chief Investment Office

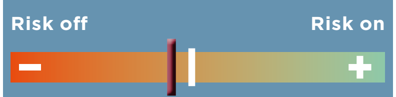
Markets have seen some relief in a year that overall is likely to be remembered as among the most challenging for investors. But the negative trend reverted somewhat with gains for the S&P 500 and select Treasury Indices. This recent market move has been supported by an alignment of stars on various fronts: **(1) US inflation on a downward path,** wherein we believe the market rally and the exuberance is excessive, as the Fed will remain focused on the inflation target and it is too early to claim victory there; **(2) the earnings season** was bad but not as bad as feared; **(3) China's Covid policy relaxation,** which has happened earlier than expected, but full reopening will be in 2024; and **(4) geopolitical uncertainty,** with regard to which **there has been some pause after elections** – in the US, the mid-terms saw no major surprises and were quickly digested by the market, which reacted well to a divided government that should deter populist policies. Internationally, we can expect more on the US/China tensions front. In the UK, the new PM is changing the fiscal policy stance, with the focus now on tax increases and spending cuts.

These developments lead us to keep an overall cautious view entering 2023, but to tactically play some short-term opportunities within an overall well-diversified approach. In detail:

- **From a cross-asset perspective,** we have in recent weeks moved towards neutrality in equities. In particular, we have reduced our negative stance in European equities while remaining overall cautious with hedges in place. We have balanced this move by increasing sources of diversification, adding a positive view on oil and gold, and slightly increasing our duration stance on US Treasuries (UST). We remain ready to adjust this stance, as we recognise that the economic outlook is highly uncertain.
- **The "bonds are back" theme** was supported by the soft inflation reading that led to one of the strongest one-day rallies in Treasury history. However, an active duration stance remains key. Markets are interpreting any indication of lower-than-expected price rises turning into a potential dovish stance by the Fed, which, instead, is likely to wait for inflation to come in below expectations for some time before pivoting. Thus, we remain very active on duration, with currently a positive view through USTs and a keen eye on inflation and growth numbers. US inflation also reverberated in European core yields, where we maintain a close to neutral view, looking out for opportunities across curves.
- **The "bonds are back" theme is playing out also in the credit market,** with the focus staying on quality. Credit spreads have tightened since mid-October in the US and more so in Europe. However, we remain cautious on risky, low-quality debt of companies, which show a tendency to increase leverage. While corporate defaults are stable at this stage and strong company fundamentals are creating an improvement in credit ratings, it is important to note that ratings and defaults lag economic cycles. Thus, we do not see any convincing reasons to increase risks. Already, corporate cash levels, though still robust, are falling, and this is especially the case for low-rated issuers that would have difficulty raising capital during times when they need it most. Hence, companies' refinancing needs, their capacity to meet capital needs internally, and CB stances are crucial factors to watch before we alter our stance. At a regional level, though, we continue to prefer the US to Europe.
- **Our stance on EM LC debt** remains a bit cautious, **but we see value in HC debt of select countries.** We think the opportunity to increase risks in EM debt hasn't come yet, as the Fed's dovish pivot – a key factor for the EM debt outlook – still looks elusive. Having said that, early 2023 could provide some entry points. Regarding China, we expect a gradual reopening in 2023, and the pace will impact growth. In Latin America, we are cautiously optimistic on Brazil, which has been a strong performer in EM this year. But, we are closely following how Lula's policies affect the country's financial position.

In equities, we are tactically trying to capture opportunities while keeping a focus on bottom-up selection. We see the current move as a bear market rally. To assess it as a cyclical bottom for equities, we would need to see improvement in earnings and a Fed dovish tilt, but we are not there yet. In our view, US earnings expectations for next year are still high, given the dual effect of a growth slowdown and the still-strengthening dollar. In Europe, the situation is equally tricky, as some positive signs are emerging, but we need to see some progress on corporate margins and consumption before we are convinced that we are out of the woods. As a result, we stay vigilant in Europe and the US as we explore opportunities in value, quality, dividends, and the small-cap space, particularly in the US. Chinese stocks are highly volatile currently, relying heavily on news flow on zero-Covid policies and economic reopening despite attractive valuations. So, we keep a neutral stance and stay ready to re-enter when earnings fundamentals and economic growth are easier to evaluate.

Overall risk sentiment



Despite the rally, stay vigilant on risk assets and well-diversified without altering the long term risk profile.

Changes vs. previous month

- Slightly positive on Treasuries.
- Reduced cautious stance in European equities.
- Enhanced diversification and inflation hedges through gold, CHF and JPY.

Overall risk sentiment is a qualitative view towards risk assets (credit, equity, commodities) expressed by the various investment platforms and shared at the global investment committee. Our stance may be adjusted to reflect any change in the market and economic backdrop.

AMUNDI INSTITUTE

US inflation: decelerating but way above Fed comfort levels

Monica DEFEND,
Head of Amundi Institute

Annalisa USARDI, CFA
Senior Economist,
Amundi Institute

Although US inflation numbers are decelerating, the Fed is likely to maintain its "higher for longer stance" with respect to monetary policy

The US inflation outlook remains the key driver of market sentiment at this stage. A weaker-than-expected US CPI reading in October, up 7.7% from the previous year (the smallest year-over-year reading since February 2022), seemed to confirm that the peak is likely behind us and prompted a strong market reaction. The market saw this as a possible trigger for an anticipated dovish Fed pivot, which remains the main requisite to get out of the bear market. But in our view, we are not there yet.

On a month-on-month basis, headline CPI was in line with our expectations (0.44% vs forecasts of 0.48%). However, core inflation was weaker than our expectations (0.3% vs our forecasts of 0.49%). The miss in core inflation came from:

- **Core services:** the weaker than expected increase in core services was related to a significant drop in medical care services inflation, but monthly changes in other components did not show significant declines. The deceleration was in particular due to a one-off drop in costs of medical care services, which related to health insurance costs and may not be repeated.
- **Core goods:** the stronger than expected decline in core goods was driven by apparel, household furnishing and supplies and drop in used car prices. Core goods momentum is decelerating and proceeding in the right direction but there is still some progress to be made to get back to the pre-covid trends. Here, it is important to watch the dynamics of change in apparel and used car prices.

What does it mean for the inflation outlook?

Over the next few months, we expect firm core inflation momentum, while headline inflation momentum should be weakening due to the drop in gasoline prices.

- **Headline:** we confirm that headline inflation has now peaked in the US and going ahead, under our main scenario for commodities and oil, there should be a visible deceleration in year over year figures (e.g. Q4 2022 expected at 7.6%)
- **Core:** core inflation declines may be slower than headline (core is stickier), given that the services inflation momentum, even though slowing, remains quite elevated.
- **Risks:** we will continue to monitor the drag coming from core goods, which started to materialise in a faster than expected way in some categories, leading to a broad-based softening of core goods momentum and inflation.

How would the Fed respond?

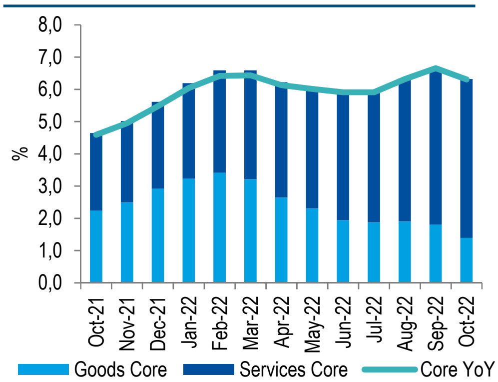
We think there is upward pressure on the terminal rates, given the robust labour markets and the Fed's resolve to fight inflation. The Fed sees better risk/reward in overtightening its monetary policy so that inflation comes under control now, and then if required later, the central bank may look to support economic activity through the numerous tools at its disposal.

Importantly, the Fed is reactive to the inflation data and is not trying to build a narrative after its last "transitory inflation" view didn't quite hold well. Instead, it is now focussing on how high to increase interest rates and how long to keep them in the restrictive territory.

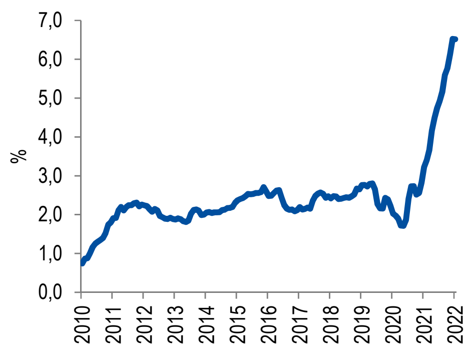
What are the investment implications?

Persistent inflation, even though on a decelerating path, underscores the need to maintain a diversified stance that goes beyond the traditional equity/bond asset classes, to include real assets and commodities among others. This would enable investors to focus on inflation adjusted returns, and at the same time, include portfolio protection through gold, USTs. However, given that pressure on yields are prevailing on both sides (slowing growth and high inflation), it is crucial to maintain an active stance overall.

1/Core CPI inflation



2/Atlanta Fed sticky inflation



Source: Amundi Institute, Bloomberg, as of 22 November 2022. Year-on-year comparison of monthly data points.

MULTI-ASSET

Stay well-diversified, explore relative value

Francesco SANDRINI,
Head of Multi-Asset Strategies

John O'TOOLE,
Head of Multi-Asset Investment Solutions

With limited forward visibility, we remain well-diversified and confirmed our positive duration stance, along with some tactical adjustments

Profit recession, tightening central banks (with divergences in forward guidance), and still-high inflation are primary market concerns. US inflation moderating has been a positive lately, but whether that deceleration will be sustained would decide the Fed's stance, which in turn is a key parameter for us to become constructive on risk assets. For the time being, China's Covid-related news flow, geopolitical tensions, and earnings fears don't allow us to alter our cautious conviction. However, we do see some tactical opportunities in equities, mainly via relative value. **This approach must be complemented by better diversification and portfolio protection through commodities (oil) and gold** on both of which we are constructive for the purpose of enhancing real returns and hedging.

High conviction ideas

On equities, we tactically moved our stance to neutral by becoming less cautious on Europe and exploring relative value in the US, favouring small caps over expensive growth stocks. But we remain vigilant to adjust this view on the cautious side amid the evolving earnings backdrop. The discounts for small caps over large caps are at extreme levels and their relative performances are starting to improve. However, Europe faces higher stagfla-tionary risks, enabling us to keep our preference for the US over Europe, where we are still defensive. In EM, we are neutral on Chinese equities, with a possibility of improvement in outlook in 2023. **In fixed income, we asserted our constructive stance on US duration.** With markets now pricing in a higher terminal rate and the Fed's aggressive tightening path increasing the risk of a US hard landing, UST valuations look attractive. The Fed may slow the hiking path to evaluate the effects of the tightening done so far. However, we are monitoring this stance actively to safeguard from yield movements against our expectations. Overall, we look across geographies, including the UK, where we are assessing opportunities arising from the latest budget announcement.

On peripherals, we adjusted our stance on the Italian curve amid the ECB's dovish guidance. We maintain a slightly positive view on 10Y BTP-Bund spreads, supported by the new Italian govern-ment's assurance that it will continue on the path of fiscal discipline.

We maintain our marginally optimistic view on US IG. Corporate fundamentals and balance sheets are strong, with high liquidity and good interest coverage, and a low risk of debt refinancing in the near term. Also, we continue to believe EU IG should outperform HY. The latter would be more vulnerable amid a recession, especially in low-quality segments if default rates (under control for now) tick higher. **The dollar remains the mainstay of our DM FX strategy, but we are now seeing some vulnerabilities in the USD risk/reward balance.** Hence, while staying positive on the greenback, we think investors should diversify towards the JPY and the CHF, but stay cautious on the EUR. We are now defensive on the GBP vs the USD and CHF, due to a weakening UK economy. On the other hand, we maintain our USD/EUR and NOK/CAD stances as cyclical economies and their respective FX should remain under pressure in the near term. In EM, we are no longer positive on the IDR/CNH, as ambiguity around reopening from lockdowns in China could create volatility. In LatAm, we keep our constructive view on the BRL vs the USD. Markets have priced in a lot of uncertainty over Brazil's new government at a time when the country should benefit from its improving macro-economic picture.

Risks and hedging

Hedging and diversification are key pillars of our cross asset strategy. We are now positive on oil, owing to supply side issues and a potential EU ban on Russian crude. In addition, gold could offer robust portfolio protection, given its safe-haven qualities and as a hedge against inflation. Separately, investors should maintain protection on HY and US equities.

Amundi Cross Asset Convictions

	1 month change	---	--	-	0	+	++	+++
Equities*	↗				■			
Credit & EM bonds					■			
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 and includes the effects of hedging components.

FX = foreign exchange, IG = investment grade, HY = high yield, CBs = central banks, BTP = Italian government bonds,

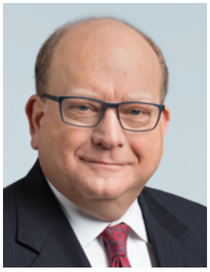
*In equities we have tactically moved neutral, while we keep a cautious approach amid a fragile economic backdrop being ready to reduce the overall stance. **We have slightly upgraded our stance with no material impact on the overall conviction level.

FIXED INCOME

Play the “bonds are back” theme with quality

Amaury D’ORSAY,
Head of Fixed Income

Yerlan SYZDYKOV,
Global Head of Emerging Markets



Kenneth J. TAUBES,
CIO of US Investment Management

We believe instead of a one-off deceleration in inflation, the Fed is likely to asses inflation trend, labour markets and overall consumption environment before altering its course of action

The Fed’s policy stance will centre on concrete signs of inflation moderating, rather than a one-off indication of inflation cooling down. **This requires a tightening trajectory (even if the Fed decided to go slow on rate hikes) and increases the risks of recession heading into next year.** Hence, forward guidance from the Fed and ECB is becoming increasingly important for inflation expectations and risk assets. On the last issue, if rates stay in restrictive territory, and the economic situation deteriorates, we could see spread volatility, notwithstanding the recent tightening. **Thus, investors should refrain from increasing risks and play opportunities in resilient segments in US IG and EM HC through careful bottom-up selection.** Regarding this, we are monitoring liquidity and the default outlook across credit markets.

Global and European fixed income

We reduced our slightly cautious stance on duration, where we hold defensive positions in Europe, the UK and Japan. However, given that the ECB is taking a ‘meeting-by-meeting’ approach, we stay flexible in adjusting this and look for opportunities across curves. Chinese debt con-tinues to offer diversification advantages. On breakevens, although we are positive on the US and Europe, we reduced this stance marginally in the US. **Credit spreads tightened recently, but investors should stay neutral/marginally positive** because spread volatility may increase if monetary policy and earnings turn unfavourable. This is particularly true for companies with excessive leverage. We continue to prefer high quality (IG), short maturity credits that have strong liquidity buffers. We like the auto sector but are monitoring how rising rates could affect the real estate sector.

US fixed income

While recent market movements indicate exuberance after inflation data and Fed statements, we think even if the Fed slows its rate hikes, this does not mean loosening of monetary policy or financial conditions. On the other hand, the consumption environment is becoming weak, as seen from consumer surveys and credit card delinquencies. Thus, **we keep our duration stance neutral/slightly constructive under an active approach** and a positive bias to upgrade if UST yields rise. Investors should not ignore liquidity and refinancing risks in corporate credit. Thus, we recommend maintaining a stable risk exposure, with a **preference for higher-quality IG credit** over HY. Within IG, we like financials over non-financials, given relative spread valuations and supportive regulatory capital levels. Securitised markets are backed by still good consumer earnings, but we are selective because volatility remains high and liquidity is low. We put special emphasis on collateral to help minimise our risks in MBS.

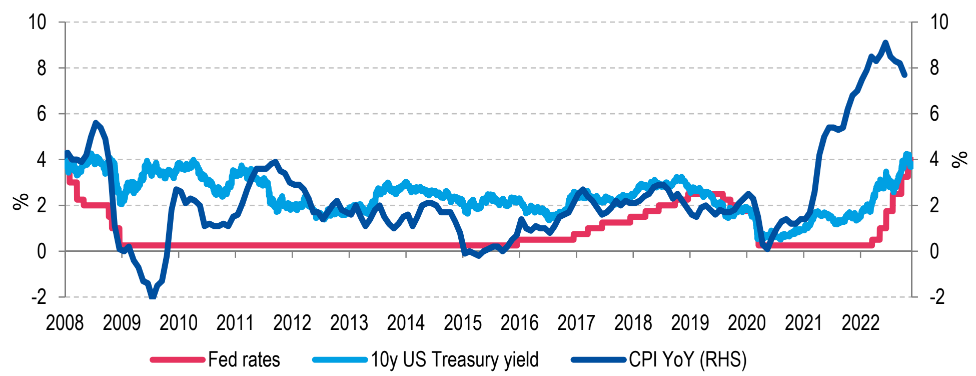
EM bonds

We stay slightly defensive on duration but are mindful of a potential stabilisation in US rates. We **favour HC bonds,** as their spreads offer good carry, but in LC, we are highly selective amid regional inflation divergences. At a country level, Indonesia and Brazil (declining inflation trend) appear attractive. We are also constructive on oil-exporting countries.

FX

Our strategic views favouring the dollar and caution on the EUR and GBP remain unchanged. However, we see opportunities in BRL to play any improvement in risk-on sentiment or a potential change in the USD trend. In addition, we are positive on MXN and CLP but cautious on EUR.

Fed will continue to assess inflation trend



Source: Amundi Institute, Bloomberg. Data as of 15 November 2022.

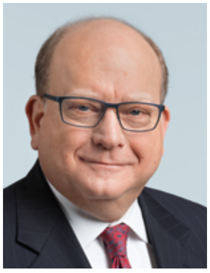
GFI = global fixed income, GEMs/EM FX = global emerging markets foreign exchange, HY = high yield, IG = investment grade, EUR = euro, UST = US Treasuries, RMBS = residential mortgage-backed securities, ABS = asset-backed securities, HC = hard currency, LC = local currency, MBS = mortgage-backed securities, CRE = commercial real estate, QT = quantitative tightening.

EQUITY

A high dispersion backdrop can offer opportunities

Kasper ELMGREEN,
Head of Equities

Yerlan SYZDYKOV,
Global Head of Emerging Markets



Kenneth J. TAUBES,
CIO of US Investment Management

Overall assessment

Rising rates and decelerating growth are creating pressure on corporate earnings. The bulk of Q3 earnings have been released, with earnings generally showing some resilience, but the picture for 2023 doesn't look rosy. We expect the downward trend in forecasts to continue and this is already priced into many companies' valuations, but dispersion is high, favouring stock pickers. Separately, supply constraints, which earlier created shortages, are now manifesting on the consumer front. For instance, in the UK, higher energy prices are affecting discretionary spending. **Hence, we are prioritising fundamental analysis, with a preference for value, quality, and dividend-oriented businesses.**

European equities

We maintain our balanced approach with defensive consumer staples, on the one hand, and quality cyclicals on the other. We continue to focus on companies with resilient balance sheets, pricing power and ability to generate free cash flows. Ability to weather the deteriorating economic situation and inflationary headwinds will be key. There are opportunities across defensives as well as cyclicals with this in focus. **We like retail banks, as unlike some other cyclicals, their net interest margins and earnings will benefit from higher rates.** In addition, at current prices, their implied expectations are very low. In contrast, we are relatively cautious on utilities, given the regulatory risk, and the technology sector as valuations are excessive, given the current macroeconomic backdrop. Overall, we remain vigilant in our search for stock specific opportunities across all sectors.

US equities

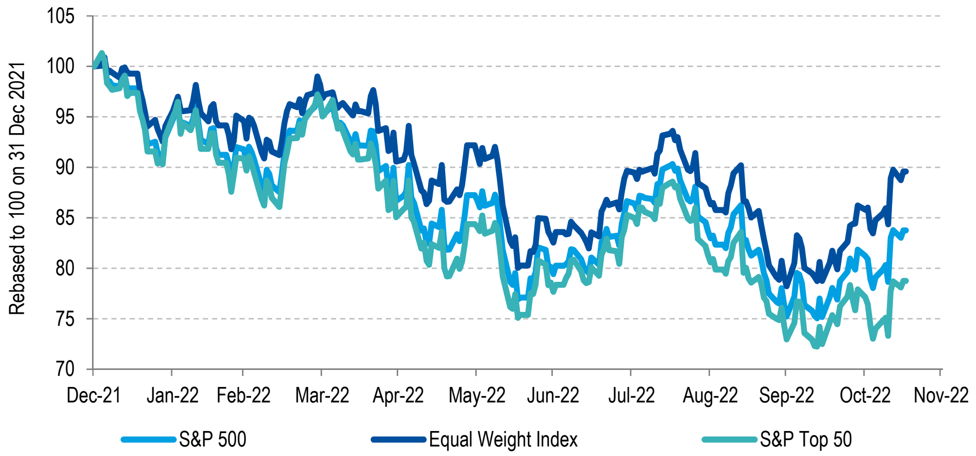
We are witnessing some cracks emerging in the markets and discrepancies in valuations across sectors, as equal weight indices are outperforming the top-heavy S&P 500. **In addition, 2023 earnings guidance is still not weak enough and is inconsistent with our view of a growth slowdown. All this collectively creates an interesting backdrop for stock selection.** In particular, we are watchful on expensive unprofitable growth names, but are positive on quality value companies that have corrected and retain the potential to deliver earnings growth. This is complemented with a valuations-driven approach that allows us to be cautious on expensive defensive, staples, utilities, real estate and large cap names. We are also defensive on mega cap names. On the other hand, prices of select beaten-down quality cyclical businesses are turning attractive. At a sector level, we like banks, health care and select consumer names. Banks are showing strong potential for returns, but we remain bottom-up and believe credit risk is an important differentiator in this segment.

EM equities

EM valuations are compelling and earnings expectations are improving, but we stay selective in a fragmented world. Our main convictions at country levels are Brazil (upgrade) and the UAE. In Asia, the Chinese economy should rebound after the re-calibration of the zero-Covid policy and more clarity is needed on this. For the time being, we stay neutral and flexible. At a sector level, we prefer discretionary and real estate, but are cautious on healthcare and China financials.

A shift down the market cap spectrum, might unearth companies where valuations and potential returns are attractive, but we stay very selective

US equity: Mega cap underperforming, opportunities down the market cap spectrum



Source: Amundi Institute, Bloomberg. Data as of 16 November 2022.

THEMATIC MACRO POLICY

When fiscal policy puts the European institutions under pressure

After several months of informal negotiations, the European Commission proposed on 9 November a reform of the Stability and Growth Pact (SGP) to be debated. Only the broad outlines of the reform have been presented. The Commission has deliberately left the most politically sensitive details open. The reform of the fiscal rules must thus be adopted next year.

Didier BOROWSKI,
Head of Macro Policy Research, Amundi Institute

The new governance proposed by the Commission goes in the right direction, but risks of failing are high

While investors' eyes remain riveted on the timing and extent of the ECB's monetary policy normalisation (key rates and balance sheet), **it is on the fiscal policy side that tensions are most acute among Europeans.**

The 'general escape clause' made it possible to suspend the fiscal rules of the SGP during the Covid-19 crisis. With the war in Ukraine, this safeguard clause was extended until 2024, allowing European states to implement stabilisation measures without any institutional constraints.

At the same time, a consensus emerged that the rules of the SGP needed to be reviewed. Many proposals were on the table. After several months of informal negotiations, **the European Commission proposed on 9 November a reform of the SGP to be debated.** The Commission calls for *"a simpler and integrated architecture for macro-fiscal surveillance to ensure debt sustainability and promote sustainable and inclusive growth"*.

Only the broad outlines of the reform have been presented. The two fundamental pillars of the pact have been maintained (a public deficit limited to 3% of GDP and a debt-to-GDP ratio below 60%). However, these numerical targets are no longer binding: the focus has shifted to the medium-term adjustment and the 'one-size-fits-all' approach is de facto abandoned. The aim is to avoid pro-cyclical fiscal policies, which is good news.

In practice, it would be up to each country to define its own debt and deficit reduction path, instead of the current uniform rules. The idea is to empower member-states. The Commission would present each member-state with a debt adjustment path over a period of four years, with an additional three years warranted to countries whose public debt exceeds 60% of GDP, provided that they commit to structural reforms and strategic growth-enhancing investments.

The new framework should address current challenges and help make Europe more resilient by reducing public debt ratios in a realistic way without sacrificing strategic investment spending. **The Commission proposes to play a greater role in assessing national budgetary plans.** Two difficulties arise here: firstly, this process presupposes calm negotiations between each state and the Commission. What will happen in the event of disagreement? The second difficulty, linked to the first, lies in the typology that will be adopted. Which criteria will be used to differentiate among countries? **The Commission has deliberately left the most politically sensitive details open.** The problem posed is anything but new: how can northern countries be reassured about debt sustainability if indebted countries are given too much leeway to avoid pro-cyclical policies or the sacrifice of necessary spending.

Divisions remain deep in the Eurozone concerning this reform. The four-to-seven-year adjustment period for countries that 'break' the rules to put their debt on a permanent downward trajectory is considered too lax by the Germans. Germany has proposed that an independent budgetary watchdog should replace the Commission to analyse debt sustainability independently and make recommendations. This proposal has little chance of being accepted by other member-states.

A new governance architecture

Debt Sustainability *AND* Sustainable Growth

Fiscal prudence

A revised EU fiscal framework
Based on a medium-term net expenditure path anchored on debt sustainability

Reforms and investment

A new tool for enforcing reforms and investment
Ensuring the enforcement of reforms and investment underpinning the agreed expenditure path

Macroeconomic balance

A revised MIP
More focused and forward-looking
Strengthen effectiveness and enforcement based on policy commitments

Source: Amundi Institute, European Commission, as of 24 November 2022.

THEMATIC MACRO POLICY

The Commission has deliberately left the most politically sensitive details open

Meanwhile, the ECB is concerned about the lack of coordination of fiscal policies. Governments must continue to support the fight against inflation, but they should not stimulate demand. This is the '3Ts rule' presented by Christine Lagarde: budgetary measures must be Temporary, Targeted, and Tailored. The fact is that they are insufficiently targeted. Moreover, countries need to align their fiscal policies and energy support measures better with the monetary policy stance. Otherwise, the ECB may have to raise its key interest rates further (i.e., more than currently expected) to anchor inflation expectations.

At present, divisions prevail and a deadlock cannot be completely ruled out. Long months of negotiations lie ahead. The Commission is due to receive comments from member states by the beginning of 2023. It is unlikely that the Europeans will reach an agreement quickly. However, they need to agree as soon as possible on the main principles and best practices for fiscal support, because, at the end of the day, the current approach may not only lead to undesirable results on inflation, but may also prove incompatible with medium-term debt sustainability. **Discussions on the fiscal policy stance in the Eurozone are expected to take place** in the context of the discussions on the reform of the EU's SGP **at the 5-6 December Ecofin meeting.**

The general escape clause will be deactivated at end-2023. The reform of the fiscal rules must thus be adopted next year, before the summer. It may be necessary to agree not to clarify everything and to allow the Commission some flexibility in the way it applies the rules, rather than adding complexity to a reform designed to simplify the existing SGP.

An agreement on the new fiscal governance architecture would pave the way for joint issuance of EU debt (for loans) to mitigate the energy crisis. The SURE (Support to mitigate Unemployment Risks in an Emergency) programme could serve as a model. Set up in 2020 to avoid mass unemployment following lockdowns, it has been a great success with investors and has proven very effective. It has particularly benefited the most indebted Eurozone states.

Finalised on 24 November 2022

THIS MONTH'S TOPIC

Defensive asset allocation extends into 2023, with a gradual increase in risk exposure later in the year

Lorenzo PORTELLI
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Amundi Institute

Silvia DI SILVIO
Senior Cross Asset Strategist,
Amundi Institute

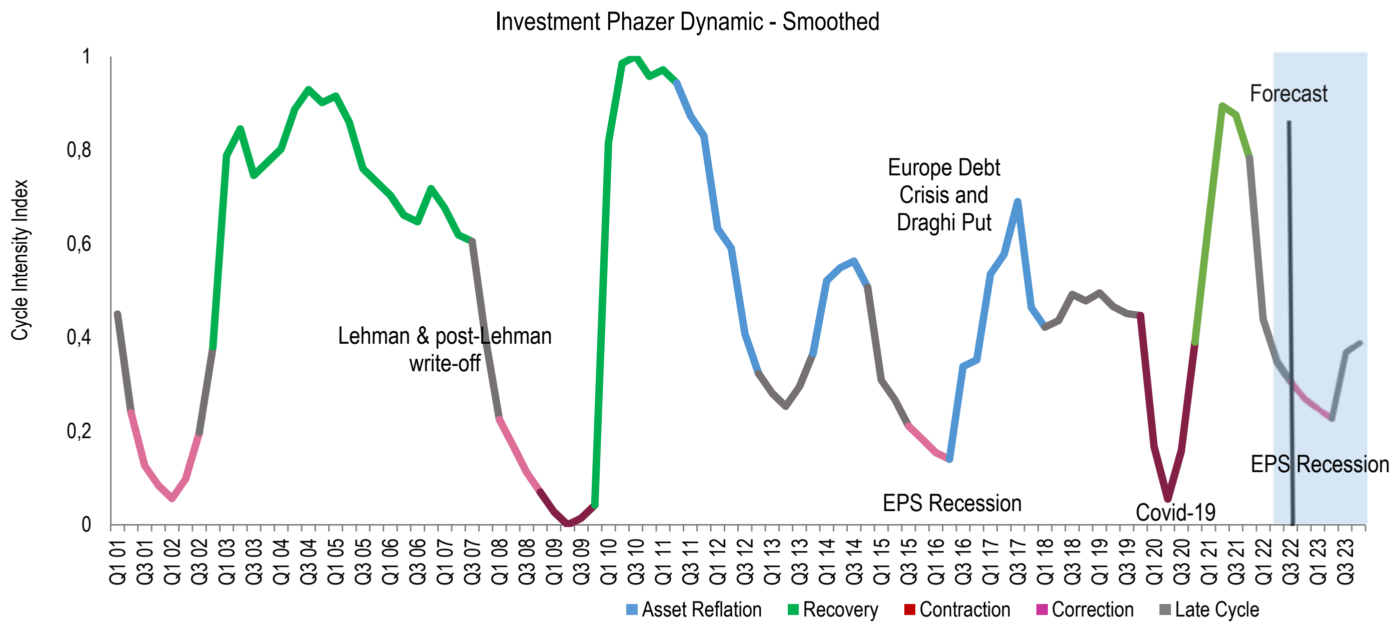
The economic backdrop foreseen for the next 12 months suggests that the ongoing correction will continue through the first half of 2023, featuring a profits recession and still elevated (albeit moderating) inflation. In H2 some of the headwinds should abate (with lower price pressures and the Fed on hold), supporting a gradual shift from the current defensive stance (with its tilt towards gold, investment grade credit and, marginally, government bonds) to increased risk exposure (mainly via DM equity and high-quality credit).

In 2023, the business cycle will be shaped primarily by two interconnected factors: a significant **global slowdown,** featuring still above-target inflation – and its fallout on monetary policy -- and the resulting **profits recession.** Growth is expected to decelerate across developed markets (DMs), ranging from sub-par levels in the United States to a few quarters of contraction in the Eurozone and United Kingdom. The cost-of-living crisis generated by the exceptionally fast pace of increase in global inflation experienced over the past 18 months and its persistence into 2023 – albeit at a slowing pace – will hit both consumer spending and sentiment severely. Central banks (CBs), which were forced to respond aggressively to the spike in price dynamics in 2022, will stay on the **hawkish** side at least until Q2 2023 in an effort to ease inflationary pressures further by cooling demand and preventing any unwanted loosening of financial conditions.

Such an economic backdrop will result in a profits recession, which we foresee in Q1 and Q2 2023, with **US EPS contracting by -10% and -15%,** respectively, on a twelve-month trailing basis. Earnings and margins will be under pressure, with the former challenged by top-line deceleration caused by the dollar's strength and weaker nominal GDP growth, and the latter suffering from increased costs from the main factors of production of capital and labour. Below-trend growth and very-weak-to-negative earnings are the main features of the correction phase and, according to Amundi Institute's Investment Phazer, will be the prevailing economic regime from Q3 2022 and should persist through the first half of 2023.

Over this period, the resulting asset allocation is predicated upon **a defensive stance,** with a tilt towards gold and investment-grade (IG) corporate bonds. As for the position towards government bonds – which a 'typical' correction phase would favour – we believe the duration component would have to be managed more actively than during similar regimes in the past. Indeed, recent downward surprises to US inflation readings (i.e., October US CPI) are unlikely to trigger a clear dovish

Advanced Investment Phazer Regimes occurrences since 2001



Source: Amundi Institute. Data as of November 2022.

THIS MONTH'S TOPIC

Global slowdown amid still elevated inflation to characterize most part of 2023

Fed pivot, and the hawkish stance is likely to persist well into the first half of 2023, adding upside risks and volatility to government bond yields in H1.

When moving into the second half of 2023, the expected sizeable correction in inflation dynamics expected in H2 will be a crucial driver of an improvement in the business cycle and **a switch from correction to late-cycle.** Despite the ongoing economic slowdown, price pressures should ease but remain above average pre-pandemic levels and CB targets on a YoY basis. In the United States, headline inflation momentum should keep weakening. After having peaked at 9% in Q2 2022, headline US CPI is set to print at a more moderate pace throughout 2023, mainly as a consequence of a drop in gasoline prices, and stabilise at an average YoY rate of 4.1%, compared to 8.1% in 2022. However, the main source of price stickiness will be **core inflation,** as core PCE is expected to average 3.5% YoY in 2023 compared to 5.0% in 2022. Here, while momentum is fading in the core goods component, the opposite is occurring in core services . Indeed, services price dynamics rely on rents, where the deceleration currently materialising in actual rental prices should be reflected on official CPI figures only at a later stage, probably from Q2 2023 onwards.

To sum up, the multi-decade PPI peak seen in 2022 should more than halve – in YoY terms – next year on a lower-base effect and a more benign commodity outlook. Finally, developments on the cost of labour will also be crucial in sizing the risks of a wage-price spiral and its fallout on the monetary policy stance, which should be tightened further in the event that high inflation expectations become entrenched.

The above inflation scenario is the backdrop for Amundi Institute's Inflation Phazer, which is indeed signalling a transition from the **hyperinflationary** regime that has prevailed in 2022 – and is highly likely to persist until Q1 2023 – to the more benign **inflationary** regime that has historically featured YoY price pressures in the 3-6% range. Although still above target, moderating price pressures should mitigate the burden of the rising cost of living on consumers, allowing an economic recovery from first-half lows and causing the Fed to halt interest rates hikes.

From an asset allocation standpoint, on-hold monetary policy – with the next move expected to be a cut – should make yield **curves bull-steepen and conditions supportive for risky assets,** with a tilt towards DM equity and high-quality credit.

Finalised on 21 November 2022

THEMATIC

European fixed income: the difficult equation if the energy crisis persists

Beyond the impact of domestic economic variables, euro rates are determined by the energy crisis and political monetary choices. The combination of a new regime of higher energy prices and persistent expansionary fiscal policy could lead to a debt supply shock and persistent inflationary pressures.

Valentine AINOUZ,
Head of Global Fixed Income Strategy, Amundi Institute

Sergio BERTONCINI
Senior Fixed Income Research Strategist, Amundi Institute

The combination of a new energy regime and persistently expansionary fiscal policy could lead to a debt supply shock and persistent inflationary pressures

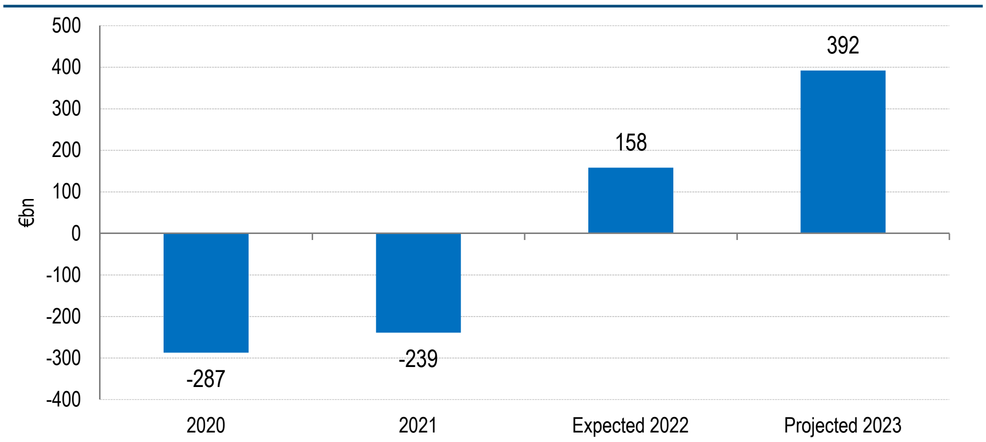
The energy crisis will be the main economic drivers in Europe

- **Economic growth is slowing.** The slowdown will accelerate in 2023 with the end of the Covid-19 catch-up effect, the impact of higher production costs, and the cumulative effect of monetary tightening. Leading indicators already point to recession in the United Kingdom and Eurozone.
- **The key question for investors remains the impact of lower economic activity on inflation.** The economy is in a better position in the United States than in Europe, as US inflation is mainly demand-driven, while Eurozone inflation is cost-driven. Indeed, in the Eurozone energy-price inflation, at 41.5%, remained the main driver of headline inflation.
- **The price of energy in Europe could remain high and volatile for longer, if Russia pipeline flows do not resume.** In recent weeks, gas prices have dropped in a context of high storage levels and mild temperatures. EU gas storage sites are now 95% full, above their five-year average. Even medium-term prices are down, but the outlook for next year remains challenging. The process of filling EU storage sites over the summer of 2022 benefitted from two factors that might not be repeated in 2023: (1) Russian pipeline flows during the summer; and (2) lower liquefied natural gas imports by China due to its economic slowdown and Covid-19-induced lockdown. It is important to note that non-Russian pipeline suppliers have limited upside potential. Thus, if Russia pipeline flows do not resume, Europe will compete with Asia for the supply of its liquefied natural gas. If China returns to the market more aggressively, Europe could find it far more difficult to plug the supply gap.

In the medium term, the combination of a new energy regime and persistently expansionary fiscal policy could lead to a debt supply shock and persistent inflationary pressures

- The EU has implemented expansionary fiscal policies to limit the impact of the energy crisis. Since the start of the energy crisis, €573bn has been allocated in the EU, of which €264bn earmarked by Germany alone, according to Bruegel. Fiscal support limits the downside impact on economic activity by preserving household purchasing power and limiting production cost increases for businesses.
- However, if the energy shock is not temporary, these expansionary fiscal policies present two drawbacks:
  1. Expansionary fiscal policies would encourage inflationary pressures by encouraging second-round effects on non-energy prices.
  2. European governments will encounter difficulties in financing their measures, especially in a context where the central banks would begin to reduce the support they are providing.
- It is important to note that the ECB ended its support for the euro rate market in mid-2022. In 2015-22, the ECB absorbed all new financing needs of Eurozone countries. In the short term, the risk is limited. Eurozone governments have accumulated cash since end-2019. General government liquidity

EMU-10 net bond dynamic, net of ECB QE, €bn



Source: Amundi Institute, Bloomberg. Data is as of 25 November 2022.

THEMATIC

Net debt issuance excluding ECB flows will jump to €390bn in 2023 from €160bn in 2022

Government deposits held at national central banks are still above €500bn, more than double the pre-pandemic levels

deposit at ECB amounted to €578bn as of October 2022 (about €250-300bn before Covid-19). In the medium term, one can wonder about the capacity of the euro rate market to finance governments' needs if the crisis persists and if the fiscal support is maintained.

In this scenario, the ECB would be in a tough position

A central bank has few tools to fight cost-driven inflation, as rate hikes have no direct impact on energy prices. ECB monetary policy tightening aims at keeping inflation expectations anchored and avoiding a depreciation of the euro, which would fuel inflationary pressures. In case of persistent high inflation, the ECB could have to make a trade-off between inflation and financial stability. However, central banks will only be credible when implementing dovish surprises, if inflation rates progress satisfactorily towards the targets. Otherwise, the risk is that this more accommodating tone will be accompanied by greater pressure on the currency and inflation expectations.

Beyond the impact of domestic economic variables, euro rates are impacted by the energy crisis, the Fed's monetary policy, and political-monetary choices

Risks of a severe recession pose some downside risks to yields. However, the impact of persistent high energy prices is likely to lead to both persistent inflationary pressures and a much looser fiscal policy stance. Thus, beyond the economic variables, the euro bond market depends on:

- Exogenous variables: pressure from Fed rate hikes on the euro and energy prices.
- Political choices: the EU's fiscal support and the ECB's potential trade-off between inflation and financial stability.

We foresee the terminal rate at 2.5% and the ten-year Bund yield increasing in the range of 2.3-2.5%.

Finalised on 25 November 2022

Jump in net bond issuance net of ECB flows in 2023 to €390bn from €160bn in 2022

Our initial projections for next year point to an overall volume of EMU-10 countries' net bond issuance close to €390bn. This means an increase by roughly €30bn compared to net bond issuance expected in 2022, which is estimated to be close to a cumulated €360bn level by year-end. In terms of area breakdown, among EMU-10 countries, dynamics point to an increase in funding for overall core countries and to slightly lower levels for periphery ones.

Most focus is on the dynamics of net funding, net of ECB flows. We are coming from strong QE support, since between 2015 and 2022 the purchases of the ECB cover much more than the net issuance of sovereign bonds of the EMU-10. This year, although purchases ended in H1, ECB absorption of net funding should be close to 56% of EGB yearly net issuance (or €200bn) and of a higher share of overall additional market debt, on the back of negative volumes of bills net issuance year to date.

The level of uncertainty in forecasting next year supply looks higher than in past years. Risks are high of both downside revisions: (1) Possible rise in needed fiscal support at the national level, (2) Possible start of QT and the upside (3) Treasuries use of accumulated cash, (4) T-bills issuance.

THEMATIC

Recent developments do not change our expectations for the Russia-Ukraine war

Anna ROSENBERG
Head of Geopolitics, Amundi Institute

Despite the downside pressures, it remains our base-case expectation -- at 35% likelihood -- that a ceasefire in H2 2023 could lead to an end of the war

The next most likely scenario is a conflict that lasts for several years

The war in Ukraine will continue to dictate Europe's prospects in 2023. It will shape local and EU politics, energy security, industrial policy, and international relations. In this article, we outline our expectations for the next phase of the war and offer an optimistic prospect for peace negotiations to lead to a cessation of hostilities in the second half of the year.

Much has happened in recent weeks in the Russia-Ukraine war. The United States has raised the prospect of negotiations, the Russian military left Kherson, emboldening Ukrainians, while a missile killed two in Poland highlighting how easily the war could escalate beyond Ukraine. Expectations are rising that Ukraine is now more willing to sit down for talks given the US change in rhetoric and Russia's destruction of critical infrastructure ahead of the cold winter months.

Despite these developments, we are not changing our assumptions for the war. Risks remain tilted to the downside, as most scenarios lead to a negative outcome for Europe (in combination a 60% likelihood). **Despite the downside pressures, it remains our base-case expectation -- at 35% likelihood -- that a ceasefire in 2023 (most likely towards year-end) could lead to an end of the war. Our rationale is that:**

- Western support should wane, as the public in Europe and the United States feels a greater economic squeeze next year, causing policy makers to pressurise Ukraine to seek negotiations. These pressures will increase throughout 2023.
- Ukraine will want to fight to regain territory for as long as possible; it will not stop before Western support actually begins to decrease or before it is militarily exhausted.
- Ukraine will only agree to negotiate if NATO offers sufficient security guarantees to deter Russia from launching a new attack after refuelling following a ceasefire. Because the West will be keen to see the conflict end, we expect the West will be willing to grant Ukraine sufficient guarantees. On the Russian side, Russia will have been able to gain and defend some territory beyond the 24 February battle line to be able to claim victory domestically, but it is militarily too exhausted to gain more territory.

The next most likely scenario is a conflict that lasts for several years. Recent signs out of Russia give the impression that Russian President Vladimir Putin is preparing for a long war. The school and University curriculum were amended to include military training and to create a pro-Russian narrative around the need for and goal of the war:

- For this scenario to materialise, both sides would need to be able to keep up the war effort over time with differing levels of intensity.
- Even if Ukraine's military support weakens, the country can sustain an insurgency, as its fighters are better trained compared to less motivated Russian recruits.
- Russia still has significant resources for mobilisation and can reposition troops from other locations (e.g., Syria, Azerbaijan). Russia may decide to 'wait' for Western fatigue in supporting Ukraine to weaken Ukraine's defences.

The other likely scenario in our opinion is the risk of a direct escalation with the West (25% likelihood), either in or beyond Ukraine. The most plausible event leading to a direct war with the West has hitherto been a targeted nuclear attack within Ukraine. However, recent events in Poland raise the prospect that a direct war with the West could also happen because of other developments. So far, it seems the missile killing two in Poland has been an accident caused by Ukrainian forces to defend from Russian attacks. However, investigations are ongoing and the outcome does matter. Given Russia's way of waging war, it is not implausible that these missiles were planned by Russia to send a warning sign. While this is not our expectation, the incident serves as a reminder of how quickly an escalation could occur.

Overall, **we consider the nuclear risk underappreciated.** The most obvious nuclear risk results from an 'accident' around the nuclear power plant Zaporizhzhia given it is exposed to frequent shelling. The fact that the leaders of Germany, the United States, and France felt compelled to get China's Xi Jinping to voice publicly his opposition to nuclear escalation is evidence for how high the United States and the EU consider this risk to be. The change of tone in the United States (calling for negotiations) is also likely the result of concerns over what Russia may be willing to do the more it is militarily humiliated. It is also important to remember that Russia's military doctrine makes nuclear escalation more likely.

There are several other low-likelihood scenarios, which include a Russian 'victory', a Ukrainian 'victory', and a power shift in Russia that leads to an end of the war. However, a power shift in Russia would more likely lead to a more hawkish leader taking over rather than a benign figure, increasing the prospect of escalation. **Lastly, there is no such thing as a Ukrainian 'victory' as it would precipitate a humiliated nuclear power in the epicentre of Europe posing a constant threat to Western Europe. Equally, a Russian 'victory' would increase the risk that Russia would go beyond Ukraine.**

Finalised on 24 November 2022

THEMATIC

China housing policy: better late than never

The latest support measures the Chinese governments announced on housing have sought to re-establish lifelines for struggling developers, clarifying that credit forbearance would not be considered as stepping on the red lines. After sharp deleveraging over a year, stabilising the market is now the priority.

Ethan ZHAO
Credit Analyst

Claire HUANG
Senior EM Macro Strategist, Amundi Institute

On 11 November, China's PBoC and CBIRC (Banking and Insurance Regulatory Commission) jointly **released** the **Notice on Implementing Current Financial Support for Stable and Healthy Development of Property Market,** with **16 points of policy measures** guiding financial institutions to support the property market.

This is the first high-level comprehensive policy package introduced since the outbreak of the property sector crisis. It provides unprecedented specific instructions in the banking and financial market to address various hot issues, including **financing for real estate companies, supporting project delivery, solutions for distressed companies and projects, protecting mortgage borrowers, and supporting rental housing.**

We found that many of the policies in the notice have already been carried out, but the notice reinforces them with more standardised and detailed guidance for implementation. Meanwhile, several policies in the notice are brand-new and provide solutions to some of the most important problems.

In our view, the notice demonstrates a strong supportive signal from the financial side that the government is changing its stance: 1) from scattered support to more comprehensive and practical measures; 2) from demand-side stimulus to also engaging supply-side support; and 3) from project-level support to also including company-level solutions. The notice tries to consolidate the policies and involve all the related stakeholders and gives more clear guidance to encouraging financial institutions to implement the old/new policies in a more pragmatic fashion. **That said, what matters is implementation by financial institutions, and we still need to take a case-by-case approach in terms of single-name analysis.** The notice reaffirms that the targets are the companies that "have a healthy financials in general but face short-term liquidity difficulty".

For the overall market, the notice on 11 November further reduces the tail risk of a systemic crisis. In fact, Chinese governments have been easing up on the demand side since a year ago. Household financing conditions have been relaxed significantly. Reassured by additional supports from the governments, we expect household confidence to improve and maintain the view that home sales are likely to stabilise towards yearend (see **Where is China heading to?**).

Finalised on 23 November 2022

The new policy pack reduces further the tail risk of a systemic crisis

Category	Policy point
Keep stable and orderly financing for the real estate sector	1. Stabilise construction loans for developers
	2. Support reasonable demand for personal mortgages
	3. Stabilise funding for construction companies
	4. Support extensions of existing loans
	5. Maintain stable bond financing, assist good-quality developers in issuing bonds
	6. Keep stable trust loan financing
Financial services for project delivery	7. Support policy banks to provide special loans for project delivery
	8. Encourage complementary financing from financial institutions to aid delivery
Risk mitigation of distressed developers	9. Support financing for project M&A
	10. Explore market-oriented supporting measures
Protect legal rights of housing finance customers	11. Encourage bilateral negotiation of mortgage extensions
	12. Protect personal credit scores
Phased adjustment to some financial management regulations	13. Extend the regulatory transition period for exposure limits of real estate loans
	14. Phase in optimisation of M&A financing policy
Support rental housing financing	15. Optimise rental housing funding services
	16. Broaden funding channels for the rental housing market

THEMATIC

Lula is back and already scoring goals

Lula netted a goal in Egypt at COP27 in the fight against climate change. However, it was an own-goal on the spending front that unsettled the markets and threw doubt on expectations of a prudently populist policy direction. We still believe Lula's policies will be of a centre-left nature, with the help of the markets, though risks have risen.

Patryk DROZDZIK
Senior EM Macro Strategist, Amundi Institute

Lula is aware of fiscal, economic, and financial constraints, but is equally fixated on his ESG agenda that is not fully comparable with country's macro-stability objectives

At COP27 in Egypt, Lula proclaimed Brazil was back in the fight against climate change and deforestation

Exactly one week after China's Xi Jinping became the country's three-term president, Luiz Inácio Lula da Silva (Lula) was elected as the head of the Brazilian state for the third time himself. Unlike in China, the presidential election in the Latin America's BRIC representative was contested very closely. As expected, Lula defeated the sitting president 51-49% on average, but by the narrowest of margins (1.7pp) in the country's elections history.

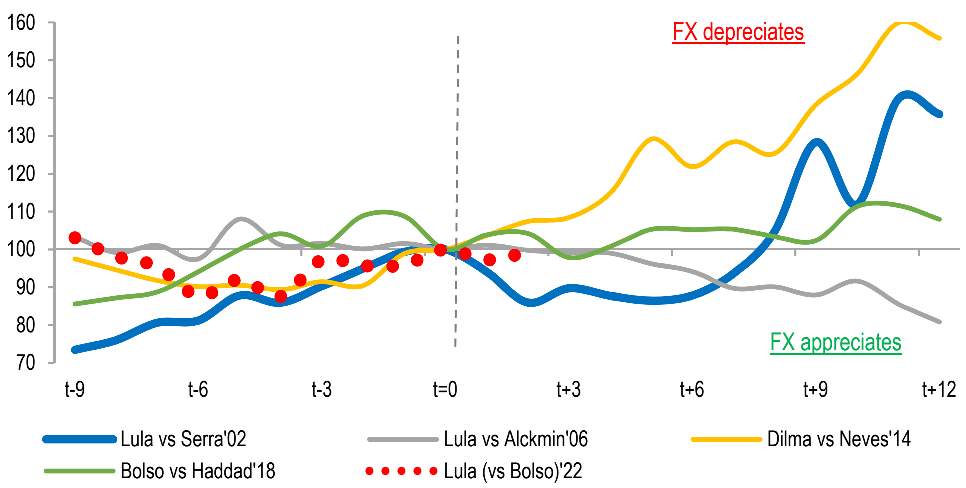
Lula's victory also marked the region's record books. All four presidential contests (Peru, Chile, Colombia, and now Brazil) over the past 18 months have been won by leftist candidates. However, the political pendulum has not exactly shifted leftward in Brazil, and there are signs it is shifting in the other direction in the rest of the region, as well, as Chileans overwhelmingly rejected the leftist new Constitution, for instance. This supports the view that the region voted against the establishment, rather than for the left. In Brazil, while the incumbent lost the presidential race, Bolsonarismo is alive and well. Candidates supported by Bolsonaro won half of the gubernatorial races, including in three of the most populous states, and plenty of seats in both chambers of Congress – Bolsonaro's party is bigger even in representation than Lula's Partido dos Trabalhadores (PT). In fact, Congress is now leaning centre-right and serving a role of checks and balances.

Given the highly polarised race, it should have come as no surprise that emotions took over early on, despite Lula's calling for unity and nearly all political actors recognising the election results. After staying on the side-lines for a couple of days, Bolsonaro eventually 'conceded' and overall surprised on the upside, behaving, rather than instigating. While disruptive, the protests did not turn out as disorderly, prolonged, and economically damaging as the trucker strikes of 2018 or those seen throughout the rest of the region more recently.

The transition process was handed over to a well-respected Vice-President Geraldo Alckmin, but the formation of the economic team to a far less orthodox PT's Aloizio Mercadante. With no finance minister in place yet – Lula will fill the key position only in the coming weeks – the transition team took a far more ambitious and confrontational stance on creating extra budgetary room to meet and fit PT's immediate campaign promises. The constitutional amendment (PEC) proposed to take the entire Bolsa Familia 2.0 out of the spending cap, which, together with other add-ons, amounts to around 2% of GDP per year and lasts for four years, the entire presidential term. The markets expected a much smaller waiver in size (slightly more than 1% of GDP) and duration (one year), not one that is equivalent in total expenditure to the entire pension reform savings over a period of a decade. That is as much of an own-goal as it gets in any football VAR analysis.

However, the signalling since the proposal was revealed has been more constructive. Most recently, alternative PECs have surfaced of a much more prudent nature in both duration and size, but we doubt that such a big watering-down is realistic. Lula also stressed fiscal responsibility was important though

Brazilian elections and FX



Source: Amundi Institute, CEIC. Data is as of 20 November 2022.

THEMATIC

Lula will be a pragmatic populist despite actions as of late that have been more populist than pragmatic

without checking all of the markets' boxes. This is a good change in momentum for once.

The recent events highlight the mutually exclusive cross-currents at play in Brazil. While markets are laser-focused on the fiscal story's remaining anchored, Lula's PT is crystal-clear about wanting to spend more freely. Lula himself is pragmatic and not much of a leftist ideology like Dilma Rousseff, as he wants to rule by wider consensus, also because of the lack of clear social and political support, unlike in the past. **He is aware of fiscal, economic, and financial constraints, but Lula is equally fixated on his ESG agenda that is not fully comparable with country's macro-stability objectives.** This looks like a conundrum.

We stick to the view that Lula will be a pragmatic populist despite actions as of late that have been more populist than pragmatic. Markets will need to act as a football arbiter, via the centre-right leaning congress, though the latter is only a necessary, but not sufficient, condition, and refrains from repricing the real like it was a World Cup winner. Otherwise, the backstop is not binding and Lula's policy stance might start resembling Gustavo Petro's rather than Gabriel Boric's. The risks of a less benign outlook have risen also in light of Lula's confrontational towards the markets comments.

Away from home, the news has been far more encouraging. **At COP27 in Egypt, Lula proclaimed Brazil was back in the fight against climate change and deforestation.** He also wants to create a special ministry for indigenous people and hold COP30 in Brazil/the Amazon. This news highlights Lula's strong ESG credentials, as fully expected by investors.

The chart below shows a study of the Brazilian real's behaviour throughout an election cycle, with FX dynamics from six months before until 12 months after the election. It shows how the real – like financial markets – is undecided about whether Lula's administration will be more similar to Dilma's or to his own administration from 2003. In the first occurrence, an insufficient risk premium is now discounted by the currency, while there is plenty of room to appreciate if the latter prevails.

Finalised on 22 November 2022

CENTRAL & ALTERNATIVE SCENARIOS (12 TO 18 MONTHS HORIZON)

Monthly update

We maintain the probabilities of our scenarios unchanged. Some of the risk factors we identify may occur in our central scenario, which is probably not yet fully priced-in by markets. Risks remain skewed to the downside in the short term, but it would take a combination of several risk factors to trigger the downside scenario at the 12-18 month horizon. At this horizon, we believe that the downside is counterbalanced by an upside scenario, that of a rapid decline in inflation due to an easing of gas prices, a ceasefire in Ukraine, and/or to the combined tightening of global monetary policies, the impact of which can be underestimated.

DOWNSIDE SCENARIO 15%

Deep global slump

Analysis

- Worsening/expanding **war in Ukraine.**
- Energy crisis and **deep recession in Europe.**
- **Covid-19 resurgence.**
- **De-anchoring of inflation expectations,** CB lose control.
- **Recession in China.**
- **Global economic downturn** with, in a second stage, renewed deflationary pressures.
- **Global financial crisis/debt crisis with several EM defaults.**
- **Governments can no longer implement countercyclical fiscal policies.** Recession paves the way for financial repression.
- **Climate transition measures postponed.**

Market implications

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

CENTRAL SCENARIO 70%

A stagflationary episode, with rising divergences

Analysis

- **Stalemate in the Ukraine war.** We expect a ceasefire at some point in 2023; in the meantime, the situation may deteriorate further.
- **Energy crisis here to stay.** Gas prices expected to rise in the restocking phase, with no credible cap in the EU.
- **Covid-19** is an endemic disease.
- **Inflation fails** to return to CB target by 2024.
- **Deep global economic slowdown in 2023:** recession in Europe and rising recession risks in the United States and China. Modest expansion and sub-par growth expected in 2024.
- Global **nominal GDP to trend higher,** mitigating the impact on earnings.
- **CB divergences:** Fed to continue to normalise, but reduce the size of hikes; ECB to raise rates, adopt a passive QT, and activate the TPI; PBoC on an easing bias.
- **The policy mix is inconsistent across the EU:** accommodative fiscal policies, but uncoordinated and not well targeted. Conversely, the fiscal impulse was negative in the United States in 2022, but is expected to be more neutral 2023-24.
- **Climate change** disrupts the commodity cycle and adds to stagflationary trends.

Market implications

- Lower risk-adjusted real returns expected.
- Contained steepening of yield curve, govies regain their function of hedging against a deeper recession.
- Inflation hedge via gold, linkers, equities, real assets and commodities.
- EM: short-term caution, long-term real income and growth story intact.

UPSIDE SCENARIO 15%

Inflation falls back quickly, ending the stagflationary episode

Analysis

- **Ceasefire in Ukraine paving the way for peace talks.**
- **Russia partially resumes gas exports to Europe,** commodity market normalises.
- **Covid-19** recedes.
- **Inflation falls back quickly,** supply bottlenecks ease.
- **Global recession fears** dissipate and inflation gradually returns to more normal levels, easing pressure on CB.
- **Lower uncertainty,** extra savings and renewed purchasing power can fuel consumption and investment in DM.
- **Fiscal discipline** gradually restored. In Europe, a new plan (common debt) is put in place to address the changing energy mix.
- **Climate change** policies and energy transitions become first priority.

Market implications

- US Treasury curve to bear steepen.
- Favour risky assets with cyclical and value exposure.
- USD depreciation.
- Favour linkers and equities as an inflation hedge.

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

TOP RISKS

Monthly update

We keep the probabilities unchanged for the three families of risks. We see risks growing on all fronts, closely linked to each other. Economic fundamentals are deteriorating globally, which is reflected in the central scenario. The course of the Ukraine war and its potential implications can tip the scenario in either direction, but risks are tilted to the downside in the short term. We consider Covid-19-related risks (including lockdowns in China) as part of the economic risks. Risks are clustered to ease the detection of hedging strategies, but they are obviously related.

ECONOMIC RISK 30%

- **Global recession** driven by an oil/gas shock, tightening monetary conditions, and a loss of purchasing power.
- **The *weaponisation* of gas supply** by Russians could cause a **severe energy crisis in Europe,** leading to a **deep recession** (confidence shock).
- **Economic crisis in Eastern Europe** following a collapse of the Russian economy, elevated energy prices, uncontrolled inflation, and a migrant crisis.
- **Disordered CB adjustments**, which underestimate inflationary pressure and lose control.
- **Global profit recession** triggered by the global slowdown, coupled with persistent input-cost pressures.
- **Recession in China.** Zero Covid-19 policy combined with a housing crisis spiralling out of control.
- **End of the great coincidence:** with stagflationary pressure, CB and governments' goals are no longer fully aligned: the room for countercyclical fiscal policies is reduced.
- **Europe:** inconsistency in the policy mix (accommodative fiscal stance coupled with restrictive monetary policy)
- **Pandemic:**
  - Risk of a more dangerous and vaccine-resistant variant.
  - New lockdowns or mobility restrictions.
- **Climate change**-related natural events hurt growth visibility and social balance.

+ Cash, linkers, JPY, Gold, USD, Quality vs. Growth, Defensive vs. Cyclicals.

- Risky assets, AUD CAD and NZD, EM local CCY.

FINANCIAL RISK 30%

- **Sovereign debt crisis:**
  - An extended war in Ukraine would hurt DM vulnerable public finances with public debt ratios already at historic highs.
  - De-anchoring inflation expectations could lead to harsher monetary tightening and to a bond market dislocation.
  - Most countries are vulnerable to rating downgrades and rising interest rates.
  - Weak EM could face a balance-of-payment crisis and increased default risks.
- **Corporate solvency risk increases,** amid deteriorating fundamentals, rising uncertainty, and corporate margins under pressure (high input cost, double orders lead to profit warnings).
- **Widespread greenwashing and ESG investment bubble undermine the energy transition funding.**
- **USD overshooting** leads to unstable currency markets.
- **Currency wars:** currency appreciation is a way for CBs to fight inflationary pressures.

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

- Oil, risky assets, frontier markets and EMs.

(GEO)POLITICAL RISK 30%

- **Ukraine war:**
  - **Risks are titled to the downside.** There is a **60% likelihood** of a negative development of the war, including a **25% likelihood of direct confrontation with the West.** This risk grows the more Russia faces military defeats.
  - Despite our expectation for the conflict to worsen in the meantime, **our base case is an end to hostilities 2023** (most likely H2) at **35%** likelihood.
- Following mid-term election, **the United States will focus on domestic political battles, which will heighten tensions with China,** as Republicans and Democrats compete for hawkishness, **contributing to growing the 'Taiwan' risk in 2023.**
- **EM political instability driven** by higher food and energy prices, leading to a wave of social unrest.
- Iran or Korea **nuclear programmes** renewed concerns and sanctions.
- **Cyber-attack or data compromise,** disrupting IT systems in security, energy, and health services is elevated as Russia seeks to undermine Western support to Ukraine.

+ DM Govies, Cash, Gold, USD, Volatility, Defensive, Oil.

- Credit and equity, EMBI.

CROSS ASSET DISPATCH: detecting markets turning points

The turning point has occurred — Approaching the turning point — Not reached yet too early to call it

ECONOMIC BACKDROP

- Economic momentum is slowing amid persistently high inflationary pressures and weakening domestic demand. We confirm our expectations of a deteriorating US macro outlook on the back of progressively tighter financial conditions; recession risks remain prominent for mid-2023. For Europe, we confirm our expectations of a cost-of-living and inflation-driven recession during the upcoming winter season.
- Inflation-wise, we have seen the peak in the United States. We expect a progressive deceleration in both headline and core indices, although signs of greater-than-normal persistence remain. In the Eurozone, inflation may be close to peaking but is expected to remain near double digits and at stressful levels for some months to come.
- The prolonged stress on the geopolitical front and the tug-of-war between fiscal and monetary policy make the final economic outcome uncertain, exacerbating data volatility.

FUNDAMENTALS & VALUATION

- Stocks look more expensive after the recent rebound; it remains difficult to see any strong catalysts for entry points.
- Stock multiples look aligned with the current inflationary environment and tight monetary policy but are not yet discounting any recession risk. In relative value, considering high rates, they are not in favour of risky assets.
- Fundamentals deteriorated further; a profits recession is the central case.

NEUTRAL + ASSET ALLOCATION

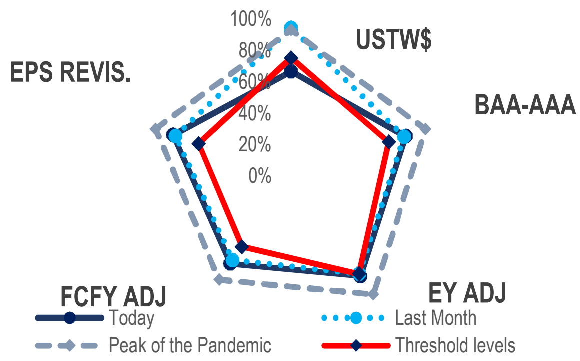
TECHNICALS

- Technicals remain highly volatile in the current market set up, yet strongly in support of risky assets for the month of November 2022. Our trend-following indicators continue to see value in being long risky assets, as most trends turned from fragmented to solid in late October. On the other hand, contrarian metrics, while far from sending out sell signals, have recovered substantially, thus calling for cautiousness towards yearend.

SENTIMENT

- Lower US inflationary pressures pushed back interest-rate volatility and financial conditions eased in response to that. Risk sentiment metrics remain fragile, but improved fast in November. Financial conditions remain tight, but eased substantially. The sharp USD sell-off has been feeding into our CAST model, which now sees a much lower risk-off probability than in October. MoMo is the only model already in risk-on mood, on the back of less-defensive investors flows and improving risk-sensitive short-term indicators.

Cross Asset Sentinels Thresholds (CAST) – The sell-off in the USD is the strong supportive factor in November. CAST defensiveness is moderating lower.



Source: Amundi Institute. Data as of 18 November 2022.

The CAST risk perception failed to show a structural increase in Q1 but has turned less favourable since Q2. EPS revisions remain negative and the credit risk premium remains high and above alert, yet the move in the USD is calling for a less defensive stance. CAST OFF probability is off its highs and entering a neutral zone.

Methodology: we consider five input variables, called 'sentinels': US trade-weighted dollar, Moody's Baa-Aaa spread, EPS revisions, adjusted earning yield risk, and adjusted cash flow yield risk. 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 any market stress conditions, with a certain level of conviction. The pentagon visualises the five sentinels, where the red line represents the alert threshold. The greater the distance above the red line, the greater the risk perception, and eventually the need to move closer to a defensive asset allocation.

AMUNDI INSTITUTE CLIPS

1 ECB concerned about recession risks

- At its October meeting, the ECB highlighted how the fight against inflation could get difficult as the economy is expected to enter a recession in late 2022, suggesting a less aggressive rate-hike path ahead.
- However, a dovish turn is not a given, as inflation remains uncomfortably high.
- We have cut our projection for the ECB terminal deposit rate to 2.50% from 2.75%.
- For all central banks, the challenge next year will be to maintain their credibility: any dovish surprise should be coupled with satisfactory progress in inflation towards target.

Investment consequences

- Twelve-month target for 10-year Bund yield unchanged at 2.3-2.5%.
- EUR/USD target also unchanged, at 0.92 in six months and 1.02 in 12 months.

2 Fed remains committed to fighting inflation

- The November Fed statement was dovish, but Chair Powell's press conference was hawkish, as the Fed did not want the market to interpret a possible reduction in the size of rate hikes as a dovish pivot or as a lack of commitment to fight inflation.
- We believe the Fed will find better risk-reward in overtightening, as it has the tools to support economic activity strongly if needed, as it showed during the pandemic.
- Focus should be on terminal rate and how long interest rates should stay in restrictive territory.
- We confirm our projection for the terminal Fed Funds rate at 5.25%.

Investment consequences

- Twelve-month target for ten-year US Treasury yield unchanged at 3.9-4.1%.

3 Inflation trends across DM

- US core inflation has been proving sticky, while headline inflation should weaken over the next few months, as gasoline prices should drop.
- US PPI dynamics have peaked and the CPI-PPI gap has been narrowing, although still above average; the transmission from lower PPI to lower CPI may be delayed, but signals are pointing in the right direction.
- Eurozone inflation – both headline and core – should peak in Q4 2022, but the upcoming wage negotiation rounds will be crucial, as they may reinforce inflation persistence.
- Eurozone inflation pressures remain strong and not completely passed through yet. PPI is sending out limited signals of moderation, and the CPI-PPI gap remains wide.

Investment consequences

- Confirm UW in equity.
- Core rates: confirm UW/neutral positioning on duration, rising real rates, flattening US yield curve.
- Peripheral rates: keep a cautious approach.
- Credit markets: US IG favoured over US HY.

4 Political and geopolitical update

- **US mid-term election:** Democrats performed better than expected, retaining control of the Senate, but losing the House. No big bills are likely to be passed over the next two years, while US-China tensions are likely to remain; more scrutiny is likely over funding to Ukraine.
- **UK fiscal budget:** It is aimed at regaining market trust, while supporting the key conservative voter base. However, more spending for 'levelling up' and increasing taxes on high income earners also highlights that the Conservatives are still targeting former Labour 'red wall' seats in left-behind areas that switched to the Tories at the last election, but have since been increasingly disgruntled with the party.
- **Brazil presidential election:** Lula won the second round. He appears keen to spend freely but may moderate his stance under further market pressure.

Investment consequences

- Markets enjoy divided governments, as populist policies get prevented.

5 China's structural slowdown already showing up

- Two sources are contributing to slower potential growth: a fast-aging population and declining return on capital.
- Full relaxation of Covid-19 curbs is unlikely until 2024.
- Housing market drag should recede in 2023.
- We have upgraded our 2022 growth outlook to 3.2% from 2.9%, due to better-than-expected Q3 data, but while cutting our 2023 projection to 4.5% from 5.2% on a dimmer Covid-19 policy outlook. 4.0% growth is achievable in the next three years, with a convergence then expected down to 3.0%.

Investment consequences

- Long HSCEI, add MSCI China and CSI 300 dividend.
- Credit: stay neutral, six-month/two-year HY is relatively cheap.
- Rates: move to neutral from short.
- Commodity: stay neutral.

6 Q3 earnings season: more negative, but not a collapse

- EPS downgrades and results were ahead of expectations. Despite beats, companies are reducing forward guidance.
- The growth slowdown and inflation impact show up in strong energy sector growth, which remains the key EPS driver. Ex-energy, US's Q3 EPS is -3.4% and Europe's is 9.6%.
- A few consumer sectors have been struggling and, especially in Europe, the real estate sector, as well.

Investment consequences

- Stay cautious on equity, while favouring the United States over Europe.
- Focus on quality, value, high dividend, and min vol.

AMUNDI ASSET CLASS VIEWS

	Asset Class	View	1M change	Rationale
EQUITY PLATFORM	US	=/+		We are witnessing a bear market rally in stocks as investors try to assess a potential change in Fed stance, which depends on inflation expectations and consumption strength. We navigate this phase via a selective approach & caution on mega caps, and focus on companies with strong business models & the ability to reward minority shareholders through dividends.
	US value	+		Value names with strong quality characteristics are preferred during times of slowing economic growth. However, in all cases, we are comparing the earnings resilience with the current stock valuations in search for opportunities.
	US growth	-		Growth names continued their underperformance this year amid tightening monetary policy. But we are watchful of some tech names that have corrected this year, but we remain cautious on growth as a group.
	Europe	-	▲	A cost of living crisis in Europe will affect corporate earnings and equities. But there is a possibility for a near-term rebound amid signs of CB dovish guidance than can boost markets temporarily, even as we continue to believe in a cautious stance. Concrete CB actions and upward earnings revisions are needed before we are convinced of a cyclical change in our views.
	Japan	=		The export-oriented Japanese market is led by cyclicals, including industrials and discretionary, which may be weighed down by a deceleration in global economic growth. However, yen movements can affect that, and we stay neutral.
	China	=		News flow around Covid is driving the markets, but we'd like to get more clarity on how government plans to proceed with its Covid policies from a medium-term perspective. For now, our stance remains neutral as we evaluate the country's shift towards a 'common prosperity' growth model and domestic consumption and geopolitical risks.
	Emerging markets-ex China	=		Geopolitical tensions, idiosyncratic risks and domestic demand are driving our views on EM, which remain a playground for stock selection. We are positive on commodity exporting countries such as Brazil and the UAE, but are cautious on Taiwan and select south-east Asian countries, including the Philippines and Malaysia.
FIXED INCOME PLATFORM	US govies	=/+	▲	Markets pricing in a higher-than-before terminal rate, attractive UST valuations, and the risk of economic growth slowing paint a constructive picture for Treasuries. However, even though the latest inflation numbers came in below expectations, we think the Fed will assess the inflation trend before altering its tightening stance. We stay very active. Real yields are also becoming attractive, especially in the intermediate range.
	US IG corporate	=/+		IG spreads are likely to be driven by corporate fundamentals, US yields, and inflation expectations. Recent yield movements have supported spread tightening, but we remain slightly positive on the high-quality IG market. However, we think investors should be selective, with an eye on refinancing and liquidity issues.
	US HY corporate	-		With concerns over deterioration in the economic environment and earnings, we remain cautious on high yield, as companies with weak balance sheets and low cash levels will be more affected. We are watchful of liquidity risks.
	European govies	=		While the latest ECB rate hikes were in line with our expectations, the forward guidance sounded a bit dovish. On the other hand, economic recession looks likely in Europe, allowing us to stay close to neutrality on core Europe duration. On peripheral markets such as Italy, the new government's affirmation of fiscal discipline is positive, but we are still watchful.
	Euro IG corporate	=		Slower economic growth and geopolitical tensions are not favourable for credit and could increase spreads volatility, even though recent ECB comments supported the IG markets. For us, sustainable cash flows and abilities of businesses to navigate potential refinancing risks are key issues in the current economic environment.
	Euro HY corporate	-		HY spreads are holding up well, owing to limited supply and still acceptable corporate earnings, but risks of deterioration in fundamentals remain. As a result, with an emphasis on capital costs and liquidity, we are cautious on HY.
	China govies	=/+		We see a continuation of monetary policy support and diversification advantages of Chinese bonds for global investors. In addition, any growth slowdown in China should be supportive of the asset class.
	EM bonds HC	=/+		Despite the recent spread tightening, HC valuations are attractive from a historical perspective. Stabilising UST yields, high oil prices, and favourable EM-DM growth differentials should be positive for HC, where we prefer HY over IG. We are cautiously optimistic on Brazil (healthy economy, declining inflation) and watchful regarding defaults.
	EM bonds LC	=		In an environment of diverging inflation and consequently different pace of monetary policy tightening, we stay very selective in LC and maintain a cautious view on EM FX. In this respect, we monitor USD movements and any indications of policy changes from the Fed.
OTHER	Commodities			Supply side pressures and geopolitical tensions (Iran/Saudi Arabia, EU/Russia) should provide some support to oil, which could act as a diversifier in the near term. But we acknowledge the risks from an economic downturn. Gold suffered this year from rising real rates, but we think, it would now act as a safe haven if the economy deteriorates. Moving into 2023, a potential change in Fed stance will also be positive.
	Currencies			We remain constructive on the USD, but believe markets would now test the Fed for its dovish pivot. Our pessimistic view on the GBP is maintained.

LEGEND

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	Negative		Neutral		Positive		Downgrade vs previous month	Upgraded vs previous month

Source: Amundi, as of 27 November 2022, views relative to a EUR-based investor. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This information should not be relied upon by the reader as research, investment advice or a recommendation regarding any fund or any security in particular. This information is strictly for illustrative and educational purposes and is subject to change. This information does not represent the actual current, past or future asset allocation or portfolio of any Amundi product.
IG = investment grade corporate bonds, HY = high yield corporate, EM bonds HC/LC = EM bonds hard currency/local currency, WTI = West Texas Intermediate, QE = quantitative easing.

Amundi Institute
ASSET MANAGEMENT

CROSS ASSET
INVESTMENT STRATEGY

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