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Investment Talks:

When things are getting blurry, stick to main convictions

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- ***Markets reaction***: *The further spreading of the coronavirus especially in Europe has triggered a selloff in risk assets and high demand in safe assets (US dollar, Treasuries and gold) over the last few days. As markets reassess the spill-over effects of the virus into the economy, volatility is likely to persist.*
- ***Adjusting the economic outlook:*** *Coronavirus is adding risk to an existing weak trend on global trade growth with fear that some stagflationary forces might result from this crisis (more de-globalisation and weaker growth). In this environment, our central scenario has been darkened, with lower GDP growth expectations in H1. Possibly, the shock can prove stronger in the short term, but we stick to the view that the sanitary situation will stabilize at some point in the coming months, leading to a catch up after, with no long lasting shock to potential growth. Additional support from Central Banks and Governments to fight any further deterioration of the economic outlook is a key assumption with this view. The US appears more insulated and supported by resilient internal demand, while Emerging Markets (EM) and Europe will be the most affected over the short term.*
- ***Investment implications:*** *The main risk now is the unwinding of recent market complacency (risk assets at historical highs in February) and the reaction of "animal spirits" that can turn into overreaction. In the short-term, some profit taking, risk reduction and increase in hedging is warranted, to try to protect investors' portfolios. Our main convictions at the moment are in the investment grade credit space in Europe and we also have a positive view on the duration in US Treasuries for hedging purposes. From a cross asset perspective, we have become more cautious on equities (European and US) and we have moved to a neutral stance in EM equity. Beyond this tactical view, we believe that the coronavirus can provide opportunities to implement investment convictions that we have identified in our central scenario, exploiting entry points and market dislocations. Cyclical value vs. growth, especially in European equities, EM equities with focus on domestic stories, EM currencies, some areas of the bond market (higher yielding government bonds in EM and Italy) and credit markets (especially the names that are experiencing spread widening despite good fundamentals) will be the first to rebound once the risks of further virus escalation will recede. As the credit market is the main area of opportunity and the main channel of risk, a strong focus on credit selection is key in this phase of the cycle. In addition, a strong focus on liquidity is paramount, not only as a defensive strategy. Liquidity can be put at work to re-enter in some attractive areas of the market once the situation normalizes.*

"We expect a temporary deterioration of the economic outlook limited to the first half of the year, and then a recovery."

The fears of diffusion of coronavirus outside China have eventually rattled risk assets in the most recent trading sessions. Investors triggered **some profit taking** in markets, which have reached historical highs and have even broken psychological thresholds in previous weeks: this is the case for European Stoxx 600, which moved above the 20-year broad trading range. The atmosphere of fear has remained consistently high only in the so-called safe assets — the US dollar, US Treasuries and gold — signalling that investors have been looking for effective hedging strategies.

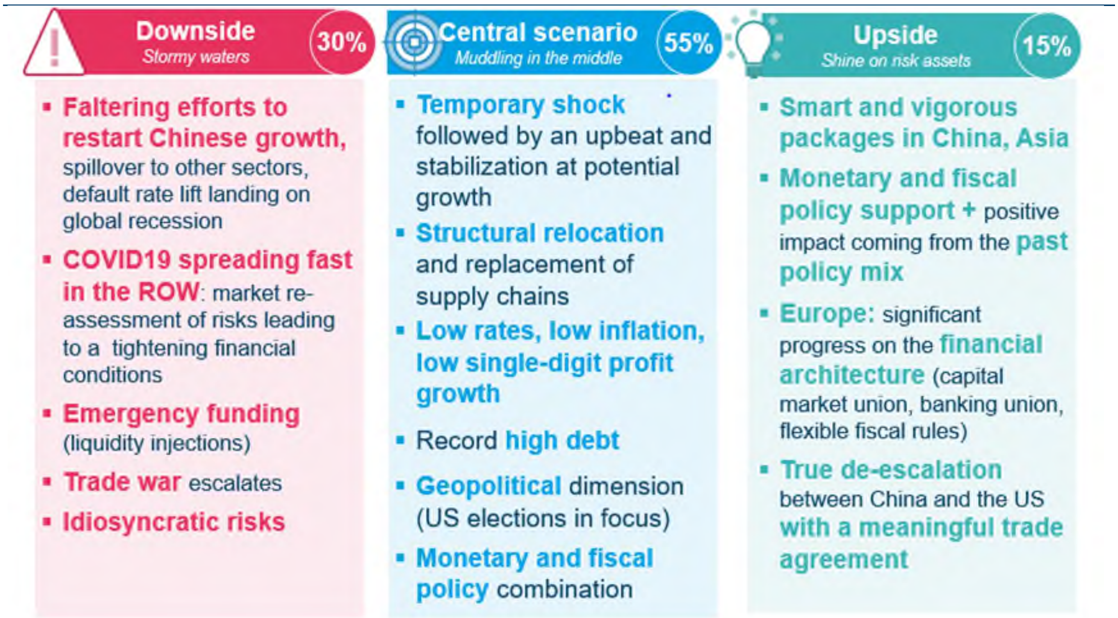
Our central scenario is for a temporary deterioration of the global economic picture in the first quarter of this year, with some possible spill-over into the second quarter, given that weaker-than-expected global trade growth is ultimately affecting industrial production and manufacturing activity and there are some impacts on the internal demand. After that, **we should see a recovery over the remainder of the year.** We believe there will be a **few months' delay to the cyclical rebound that we expected at the start of the year.**

To take into account the effects of the coronavirus, **we have revised down the growth outlook for 2020**. The slowdown in China is triggering **massive monetary and fiscal measures to avoid any further disruption in the private sector**. This should help the situation stabilize in Q2, as it is likely that the peak of contagion will have been reached by then and activities will slowly return to normal.

Beyond Asia, Europe will be the most affected region, due to a combination of lower momentum, openness of the economy and exposure to global trade, and weak Q4 2019 data (with surprisingly anaemic growth figures in main EU countries). Also, in this case, there is some downside risk to the current forecast (around 1% for 2020), depending on the evolution of the contagion in EU countries, with Italy being the most affected so far. In the US, we confirm a deceleration of GDP growth vs. the previous year. However, we believe that the economy will hold up well, thanks to the resilience of domestic demand.

Broadly speaking, **in our scenario, global growth has been downgraded to 3.0% from 3.2%, especially due to weaker EM figures** (4.1% vs. 4.4%), considering the spill-over effects to some countries deeply entrenched in the supply chain with China (Cambodia, Vietnam, Korea, Thailand) or heavily dependent on metal exports (such as Chile, Peru and South Africa).

Amundi's base and alternative scenarios



Source: Amundi, as at 24 February 2020. ROW= rest of the world.

"While in short-term some profit taking and risk reduction is warranted, we believe that the year will remain constructive for risk assets and we will continue to look for entry points."

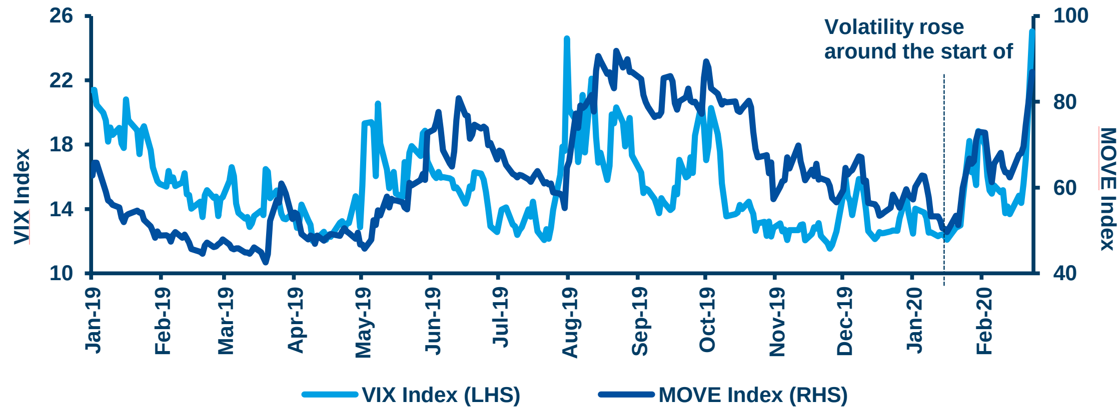
In this environment, **we believe that conditions regarding risk assets will remain moderately constructive this year** but investors should increase their level of vigilance and aim to detect the potential triggers for revisiting this viewpoint.

Clearly, the main risk now is the unwinding of recent market complacency and the reaction of "animal spirits."

Therefore, we can expect to see some profit-taking, short-term market volatility and overreaction. The good run in risky assets has been driven by the following: investors who believe the coronavirus episode will be temporary (our central scenario); those who believe that if the situation were to worsen, it will trigger much more central bank action; and, lastly, those who believe that they have no alternatives, given the moves regarding safe-haven assets.

A tactical move towards neutrality in risk exposure and an increase in hedging looks to be a good strategy to navigate this phase.

Equity and Bond volatility has been rising recently



Source: Amundi, Bloomberg, as at 24 February 2020.

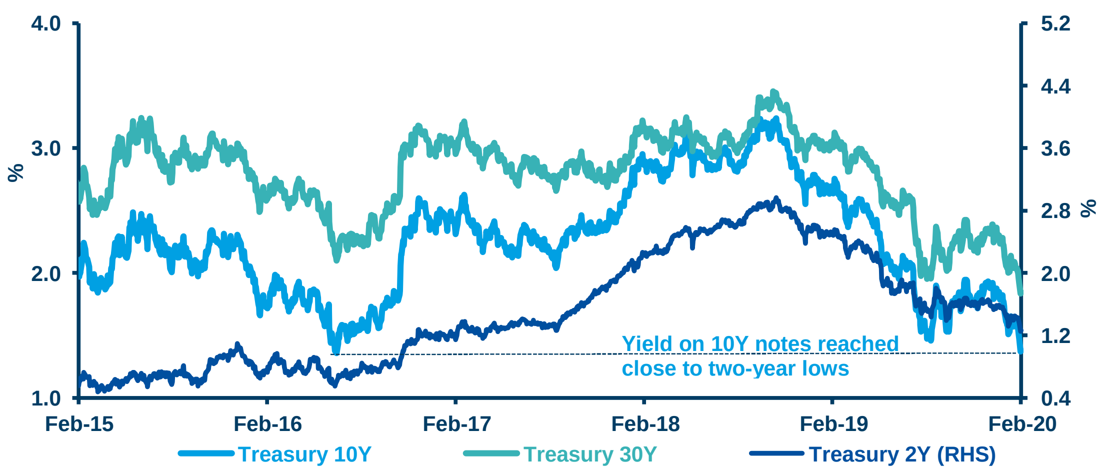
"EM equities, EM currencies, European equities and some areas of the credit markets with good fundamentals will be the first to rebound once the risks of further virus escalation recedes."

Beyond our tactical view, the coronavirus must be seen as a way to implement investment convictions that we have identified in our central scenario, exploiting entry points in some areas of the markets such as the cyclical value component in European equities (already attractive, but even more so now), EM equities (help-yourself-countries or domestic-demand stories), and EM currencies. All these stories will be back in focus once the headlines on the virus recede.

In addition, **falling core bond yields, while are reducing some hedging potential, due to the low level of yields reached, will reignite the search for yield in credit market** or in the **richer government bond segments both in EM and DM (i.e. Italy).**

We should also not underestimate the fact that if the situation worsens, Central Banks and Governments could bring monetary and fiscal stimulus to the next level, renewing the narrative of *"no bad news is good news".*

Falling core bond yields



Source: Amundi, Bloomberg, as at 25 February 2020.

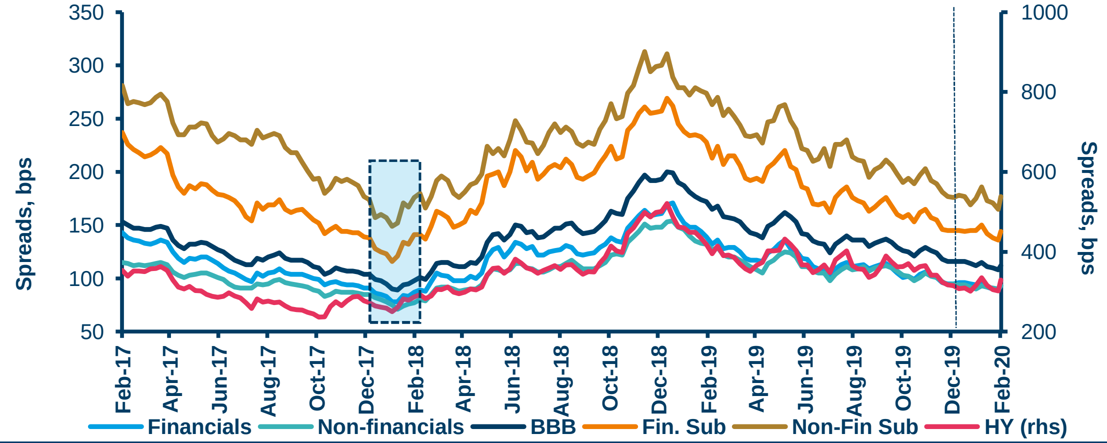
"Governments and Central Banks will likely step in should the situation worsen, benefitting financial markets."

As both the main area of opportunity and main channel of risk lies in the credit market, the main question for investors is, ***to what extent will the coronavirus generate non-idiosyncratic disruptions in this asset class?*** Disruptions can include increases in default risk, but also liquidity squeezes in the channels of financing (looming risk in China for the private sector). On China, as most of the debt market is government-related, we believe that the government will prevent large-scale shock and material tightening of the financing conditions that could impact the corporate and banking sectors.

"Credit markets are the place to look at to assess risks to the outlook, keeping in mind that some areas are already vulnerable and hence investors should remain selective."

On credit, we should differentiate between market and fundamental risks, investors should keep in mind that market risk can become fundamental risk at some point. Market risks are recoverable events but fundamental risks may well not be. In addition, we need to differentiate between issuers that will fundamentally deteriorate but from higher quality levels, which will ensure no default, and issuers that will deteriorate materially from already low levels of safety margins to default or to flirt with default.

Spreads have been tightening since the start of the year, and we can see some mild deterioration especially in high yield (HY)



Source: Amundi, Bloomberg, as at 25 February 2020.

In credit, the biggest short to medium term risk is no access to debt capital and bank markets for any but the best or strongest credits. This condition could mean certain credits may default, leading to a loss of principal. Credits that do not have pre-debt maturities occurring over the next 12 months or longer, credits that are free cash flow negative after maintenance capex or low quality credit private companies that have no access to equity are the most vulnerable. A large majority of low quality high yield issuers, B rated and lower, will fall under these categories. They will also be among weaker credits that will materially deteriorate in poor economic circumstances. These are all idiosyncratic issues, and investors should isolate them.

The second order risk is a material fundamental deterioration in a risk off and an economically challenged environment. Here we could experience serious and broad credit deterioration, and a market sell-off, at least in the short-term. Companies that have little margin of safety for even non-material revenue or cash flow deterioration would be the most affected. In this case, investors should look at an upgrade in quality in large cap stable BB/BBBs and higher quality investment grade (IG) universe. In this scenario, scale becomes very important and investors should stay away from smaller issuers. Many/most of the companies in this category are US-based, so we can take comfort from the greater US economic resilience at this point. A US recession would have extremely serious credit consequences. Fortunately, Europe has fewer issuers that are currently being challenged than does the US.

Both vulnerabilities (market and fundamental risks) reinforce our view of the credit sector requiring increased scrutiny, with a focus on credit bottom-up research and an increased attention to market liquidity.

Overall, we expect that the credit market will remain resilient especially in the IG space (Euro is better positioned), while HY market will remain under pressure, offering some attractive entry points as the situation normalizes.

"Some trends will be further reinforced by the current environment: the de-globalisation path in act, the low interest rates environment and the demand for real assets."

From a longer-term perspective, the coronavirus confirms some pre-existing trends:

- **The retreat in global trade and de-globalisation.** This should support investment themes insulated from those issues, such as domestic-driven demand countries in EM or a focus on more domestic real assets.
- **Low interest rates at equilibrium**. In the US, core bonds are providing a cushion for risky assets in reaction to setbacks (negative immediate correlation between equities and bonds), but they are also leading the rebound of risky assets (negative leading correlation bond yields/equities). It follows that duration management must be asymmetric: it is much more risky being short duration than long duration, and there is a clear role for US Treasuries in portfolios for their hedging properties. In this scenario, interest rate factor dominates the growth and earnings components of equity returns. Investors should be alert to the early signs of either a change in equilibrium rates or a shift pointing to more prominence for the real component of returns vs. the monetary component, but we have not yet reached this point.
- **Demand for real assets.** The absence of real illiquid assets is a recurring weakness as they represent an already large, but still rising component of relative value plays. De-globalisation is driving demand for real estate on the basis that it provides significant international geographical diversification. The search for a better remuneration of the interest factor (infrastructure) or simply equity-like returns with bond features is also driving demand. This mismatch in supply and demand, along with trade and pandemic noise can only accentuate this sort of safe-haven status with fast riding complacency.

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