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Investment Talks:
Navigating an inflationary environment in US and global equities

INVESTMENT TALKS

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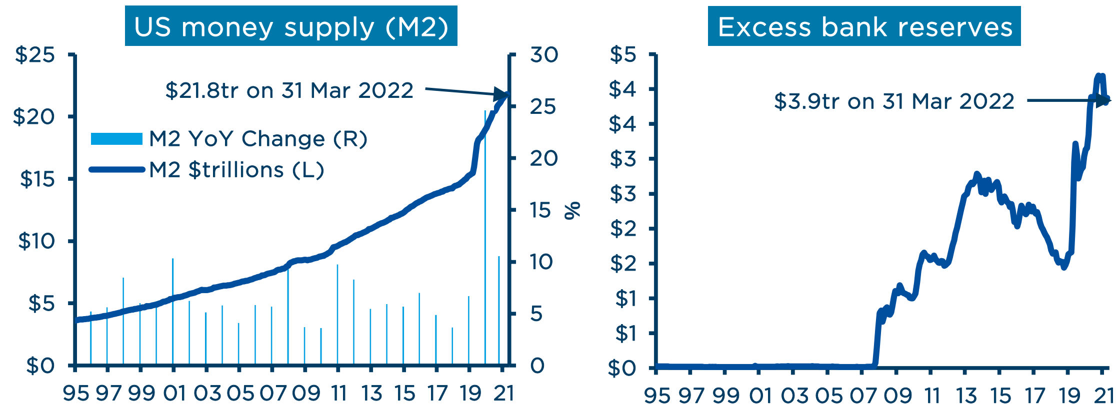
"Excessive growth in money supply, underinvestment in 'physical capital' in the past, and strong labour markets are likely to keep inflation above central bank target in the long term."

Forty years … That's how long it has been since the Great Inflation, which lasted from 1965 to 1982 and saw inflation in the US climb as high as 13.5%. According to Michael Bryan of the Federal Reserve Bank of Atlanta, it was the "defining macroeconomic event of the second half of the twentieth century … there were four economic recessions, two severe energy shortages, and the unprecedented implementation of wage and price controls". The origins of the Great Inflation were Federal Reserve policies that, similar to those of today, supported excessive growth in the money supply.

Rising money supply, healthy bank reserves indicate higher inflation going forward

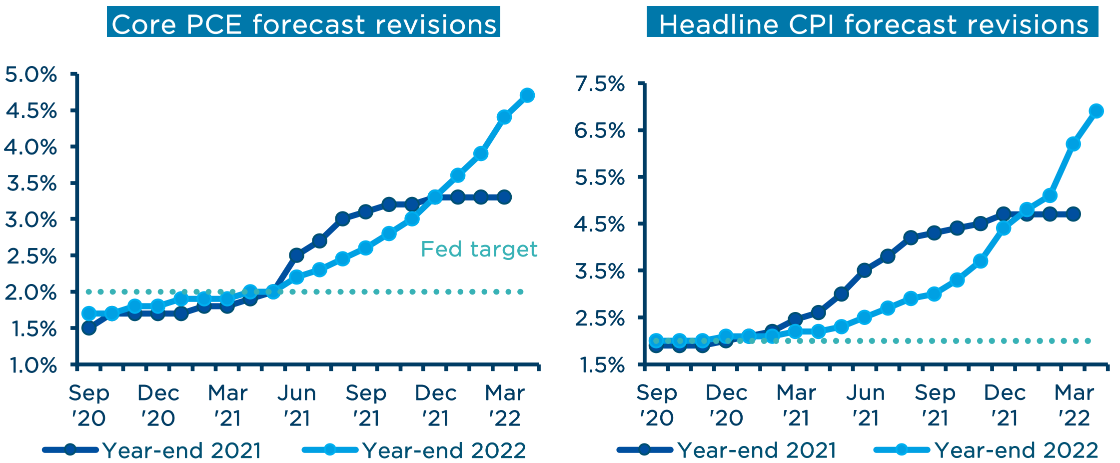


Source: Amundi, Bloomberg, as of 31 March 2022. (LHS) M2 money supply; (RHS) US excess bank reserves as monetary base total balances.

Inflation is likely to persist above central bank target

Economists' forecasts of inflation (charts below) have been above the Fed's stated target, and when coupled with actual numbers, they suggest sustained inflation over the medium term.

Inflation forecasts have defied Fed predictions

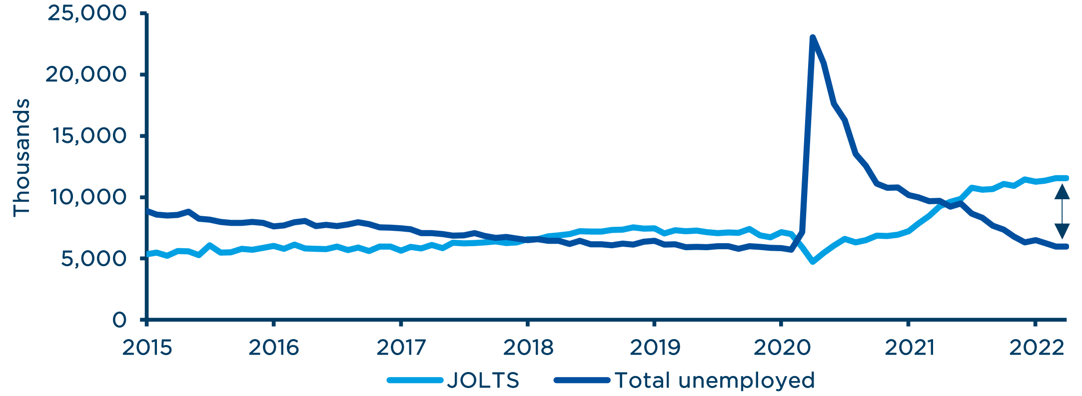


Source: Amundi, Bloomberg monthly survey of economists as of 30 April 2022. Last point for year-end 2022 forecasts refers to 30 April 2022. Economists forecasted both 2021 and 2022 year-end inflation rates each month. Core PCE = Personal Consumption Expenditures less food and energy. Headline CPI = Consumer Price Index all items.

While the current rate of inflation (the Bureau of Labor Statistics' Consumer Price Index measured 8.3% in April 2022) is well below the 1980s' peak, we believe inflation may persist at above the Fed's stated target of 2% for three reasons:

1. **The US has a labour shortage**. A sharp rebound in economic growth, coupled with an ageing population and early retirements during the pandemic, limited the availability of labour and pushed wages higher.

Labour shortages: aggravating the wage spiral



Source: Amundi, Bloomberg, as of 30 April 2022. JOLTS are total US job openings.

"The deflationary impact of Chinese manufacturing should abate as the country's working age population peaks, leading to a further rise in inflation in the developed world."

2. **There is a renewed focus on energy security and defence globally due to the Russia-Ukraine conflict**. Germany, for example, announced it would speed up construction of Liquefied Natural Gas (LNG) terminals to lessen its dependence on Russian natural gas as well as increase defence spending to 2% of GDP. We believe spending on energy security and defence will be inflationary.

3. **China is no longer exporting deflation**. For years, China has been a source of low-cost goods, accounting for 18.6% of US imports in 2020, according to the Office of the US Trade Representative. Due to low birth rates, however, China's working-age population has peaked, according to Business Insider. We believe that a declining labour force will result in higher export prices to the US.

Investment implications: a rotation towards sectors that should do well during periods of high inflation

If inflation persists, and we think it will, it would be a pivotal moment for equity investors as the types of stocks that are likely to do well in an inflationary environment are unlikely to be the ones that have performed well in recent years. We suggest the following as a path forward in equities:

What worked in the pandemic	What we think will work in a post-pandemic environment
Future-oriented	Focus on the present/current company fundamentals
Valuation-insensitive	Valuation-sensitive
US	Global

Source: Amundi, April 2022.

(1) From the *future* to the *present*

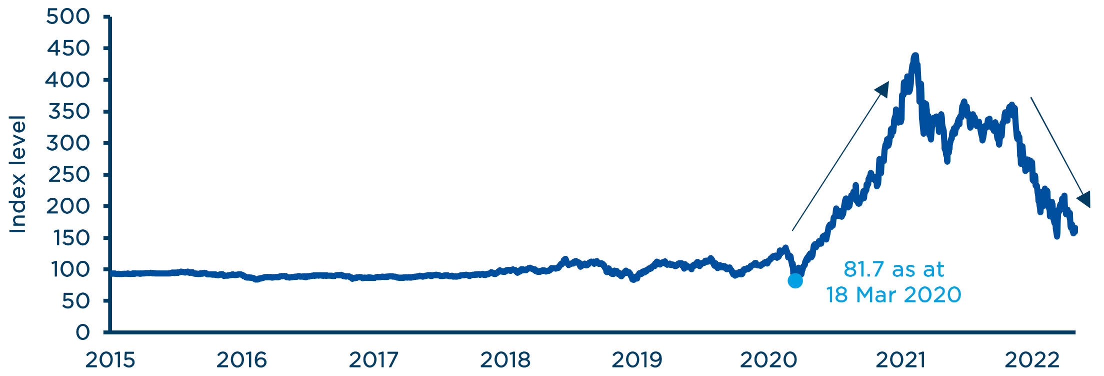
In the first year of the pandemic, the Goldman Sachs Non-Profitable Technology Index quintupled[1]. Certain social networking companies soared as people connected largely through social media in a stay-at-home environment. Investors were willing to look past near-term fundamentals (lack of meaningful revenue and earnings) to future potential. Interest rates plummeted, further supporting gains in long duration assets, which benefitted from a low cost of capital.

[1] 18 March 2020 to 12 February 2021.

"Tech stocks benefitted from the stay-at-home theme during the pandemic. But as we move ahead, markets should resume their focus on profitability and on the prices that they pay for those profits."

What a difference a year makes. An economic recovery, coupled with sharply higher interest rates, made shorter duration stocks (companies earning money) more attractive and longer duration assets something to avoid (see decline in the index below in 2022). **In this environment, we believe investors could reward companies based on their current fundamentals rather on earnings potential in the distant future.**

Non-profitable tech stocks languishing: Goldman Sachs Non-Profitable Tech basket



Source: Amundi, Bloomberg as of 4 May 2022. The Goldman Sachs Non-Profitable Tech basket consists of non-profitable US listed companies in innovative industries. Tech is defined quite broadly to include new economy companies across GICS industry groupings. The basket is optimised for liquidity with no name initially weighted greater than 4.65%.

"Valuations of long-duration growth stocks that depend significantly on cash flows way into the future are affected by increases in interest rates and, hence, their cost of capital."

(2) Valuations in focus, a case study: shift from paying *any* price to paying the *right* price

We look at a biotech company that uses genetic engineering to produce bacteria for use in industrial applications. The company generated revenue in 2021, but lost money (Bloomberg, March 2022). In anticipation of future revenue and earnings, investors paid as much as close to $15 per share for the stock in November 2021. By the end of the year, the stock was trading around $8. As of 15 March 2022, the stock was close to $3.

What changed? According to the investment bank which recommended the stock at $10 in December 2021, the answer is interest rates or WACC (weighted average cost of capital). "We estimate each 100 basis point shift in the company's WACC will clip the warranted share price by (about) $3 per share," stated the bank's analyst.

In a matter of months, the change in the interest rate environment has caused investors to focus on something they have more or less ignored in recent years: valuation. Year-to-date through 17 May, the least expensive quintile of S&P 500 stocks returned 6%, despite the overall decline in the S&P 500, while the most expensive fell 23% (see table below).

S&P 500 stocks quintile by price/earnings (P/E) ratio	Average total return (%)
Quintile 1: P/E above 36.0	-23.3
Quintile 2: 23.1–36.0	-16.7
Quintile 3: 18.0–23.1	-7.7
Quintile 4: 12.6–18.0	0.2
Quintile 5: 3.6–12.6	6.0
S&P Index	-13.7

Source: Bloomberg, year to date to 17 May 2022. Best P/E at 31 Dec 2021.

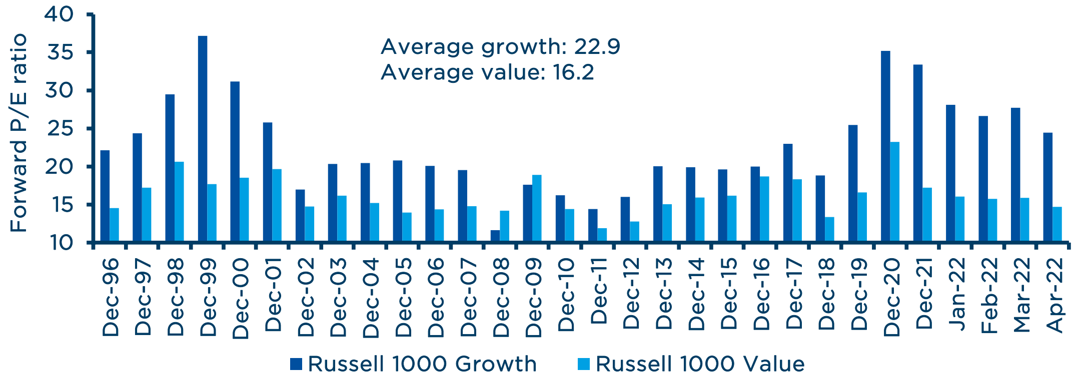
Value is currently the most attractive segment

What part of the equity market do we believe is the most attractively valued? The value universe. As shown below, despite the recent movement, value stocks currently trade at a P/E discount to growth stocks.

Amundi
ASSET MANAGEMENT
東方匯理 資產管理

"The move from growth to value (particularly high quality, less cyclical) should be supported by high valuation premiums of growth, a mild upward repricing of core yields and rising inflation."

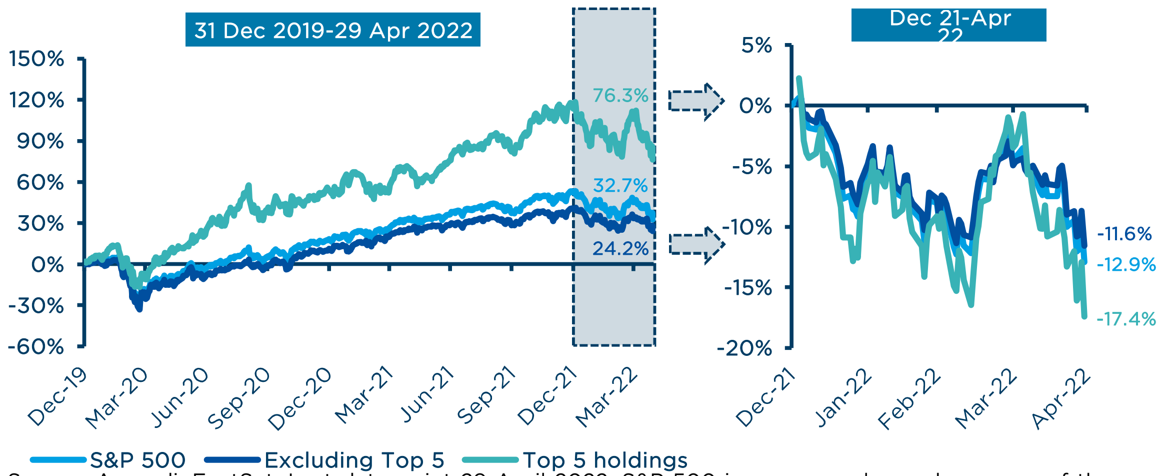
Growth's P/E premium to value is wide by historical standards



Source: Amundi, Bloomberg, as of 30 April 2022. Averages since 31 Dec 1996. P/E of Russell 1000 Value Index and Russell 1000 Growth Index shown above. Forward P/E ratio is the current price of a stock divided by the consensus analyst estimates of one-year projections of its earnings per share.

(3) Concentration risks underscore the need for active management: the S&P 500's recent performance is concentrated in a handful of stocks

S&P returns with and without top 5 holdings – 31 Dec 2019 to 29 Apr 2022



Source: Amundi, FactSet. Last data point 29 April 2022. S&P 500 is a commonly used measure of the broad US stock market. Securities listed are not meant to represent any current or future holding of an Amundi portfolio, and should not be considered recommendations to buy or sell any security. Top 5 holdings = Apple, Microsoft, Amazon, Alphabet, Meta.

"Market indices, such as the S&P 500, often expose investors to concentration risk because their performances are sometimes driven by a few stocks."

As of year-end 2021, these top 5 holdings represented 38% of the Russell 1000 Growth Index and 23% of the S&P 500 Index. Given diversification requirements, it has been impossible for diversified, actively managed US large cap growth funds to maintain the same exposure in these stocks as the Russell 1000 Growth Index. While less concentrated than the growth index, the S&P 500 has also become more concentrated than ever.

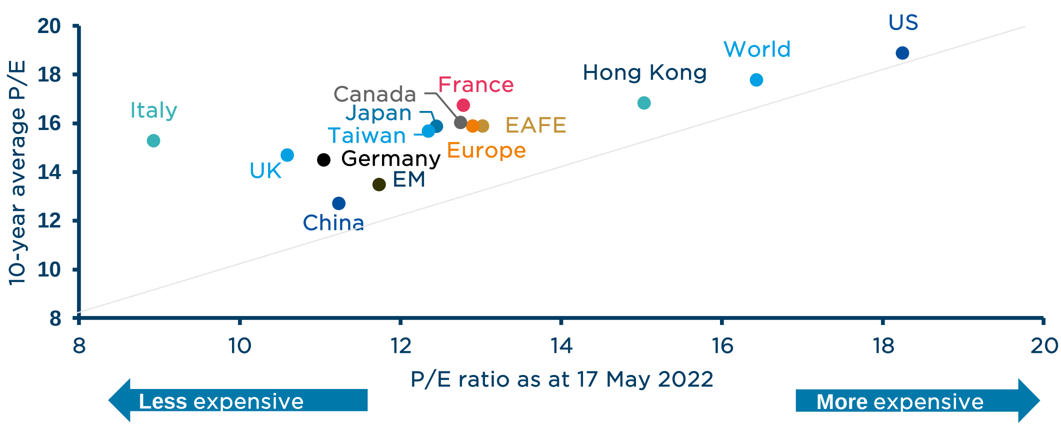
The good news for active managers is that the performances of some of these stocks have begun to wane. We believe the S&P 500 will become less concentrated in coming years as growth for the largest companies matures, regulation increases, and investors look elsewhere for returns. Active managers that are cautious on the largest stocks should benefit from this trend. For historical context, the last time concentration in the S&P 500 Index fell precipitously was after the dot.com bubble burst. The percentage of active managers that outperformed over 2000-2002 was above 60% each year. We believe the next few years may follow a similar pattern, representing perhaps the best time to invest with active managers in more than 15 years.

"Most regional markets outside the US are trading below their long-term averages."

(4) From *US* to *Global*

For years, US stock market returns have largely dominated global stock market returns, but this dominance has come with a progressively higher price tag. As of the beginning of May 2022, US equities, as measured by the forward P/E ratio of the S&P 500, traded at a premium to international equities (18.2x earnings vs13.0x earnings, respectively).

US stocks are generally more expensive than international stocks



Source: Bloomberg, as of 2 May 2022. P/E for Taiwan as on 17 May 2022. S&P 500 for US. MSCI for all others. Price/earnings ratio is a valuation measure of expensiveness using a stock's price divided its by per share earnings. Forward P/E represents analyst consensus estimates of that measure over the next 12 months.

While most non-US countries are trading below their long-term P/E averages, the US is currently very close to its 10-year historical average. In addition to the stark valuation difference between US and non-US markets, there is another potential catalyst for non-US stocks to outperform. **The catalyst could be a continuation of the style rotation from growth to value, driven by sustained inflation and higher interest rates.** If these conditions persist, the composition of international indices (see table) – which are more heavily weighted towards value sectors, such as financials, and less towards growth sectors, such as information technology – may help them outpace US markets.

Indices	Tech weight (%)	Financials weight (%)
S&P 500	27.2	11.0
MSCI EAFE	8.2	17.5

Source: Bloomberg, as of 30 April 2022.

Conclusion

We believe we are moving towards a high inflation regime, the seeds of which were already in place before the Covid-19 crisis in the form of excessive money supply, financial repression, and underinvestment in physical infrastructure. Investors should prepare for this regime shift by including equities in the value, quality space that are likely to benefit from higher inflation.

However, the rotation towards value, international, less-expensive markets in a post-pandemic environment is unlikely to be linear. It could also be affected by extreme market events, such as Russia-Ukraine conflict, when investors might prefer the resilience of the US over regions such as Europe, owing to a limited impact on US corporate earnings. But investors should note that these earnings would now be discounted by a higher cost of capital. In addition, the post-pandemic environment characterised by earnings uncertainty calls for an increasing focus on stock-picking and corporate fundamentals.