Inflation blows on markets, and investors need to act

INVESTMENT OUTLOOK | H2 2021

PART 1

Confidence must be earned

Amundi
ASSET MANAGEMENT

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KEY CONVICTIONS

We are already reaching the peak of economic acceleration. What matters going forward is what will be left of this bounce in growth and inflation.

Markets are pricing in a Goldilocks scenario: low inflation and higher growth at trend, but we will likely end up with higher structural inflation and lower growth instead.

For the first time in decades**, there is a desire for inflation.** Central Banks will let the music play on, they will neglect inflation risk for as long as possible, and they will archive it as a temporary effect.

We are moving away from the great moderation, with the end of the rule-based monetary and fiscal regime.

It takes time before institutions adapt to a new regime. The next Volker is not around the corner. Higher inflation and the volatility of inflation will be key features of this new regime. Investors believe they will wake up in the 30s, **while they will end up waking up in the 70s.**

The de-anchoring of the system may come at some point: the main risk is seeing the yield curve go out of control. **The direction of real rates is key.** The first sequence is for real rate to move down, and this is still **positive for risk assets.** The second, which is less benign, is for higher real rates.

The new regime may challenge the traditional 60/40 allocation. Investors will have to factor in inflation and enhance diversification to face the challenges of a higher level and volatility of rates.

In our view, government bonds are no longer the efficient diversifier of balanced portfolios, but they retain a role for liquidity purposes.

Duration should remain short. Investors should resist the temptation to go long duration too soon, as the direction of rates is upwards.

We believe that equities are a structural engine of returns, **a sort of real asset.** Investors should **play equities through an inflation lens: value, dividend, infrastructure.**

NARRATIVES, VALUATIONS AND THE INFLATION PATH

Markets will be tested by the temporary vs. structural inflation narratives

The COVID-19 crisis has transformed the world with far reaching consequences that markets are now starting to assess. The most important one being what will be left of the Great Recovery following the crisis.

Post-COVID narratives and the road back to the 70s

Different narratives are evolving at this point in time, leading to higher uncertainty in the market. The monetary narrative is the clearest and most advanced one. Central Bank mandates are evolving from being anchored to keeping inflation under control, to a situation where extraordinary monetary policy becomes the new normal. What is uncertain is how long this extraordinary accommodation can last without risking the initiation of an inflation spiral.

Central Banks will let the music play on, neglecting inflation risks. Higher volatility is in the cards.

On growth, the secular stagnation narrative of low growth and low inflation forever is now leaving space for new possible regimes. The first is based on the idea that we will end up back in the 70s, with inflation making a comeback as a consequence of policy measures, the retreat of global growth "back home" and a rebalancing between labour and capital. On the opposite side there is the narrative that sees secular stagnation transforming into the roaring 20s supported by the idea of a new technological revolution that will justify higher earnings at trend.

Investors think they will wake up in the 30s, but the most likely outcome in our view is that we are starting to walk down the road back to the 70s.

The coexistence of the monetary narrative coupled with the consequences of COVID-19 is creating a fertile ground for inflation and the rise in inflation expectations can further turn a narrative into a prophecy.

Where are we today? Goldilocks is priced in, but stagflation risk is on the rise

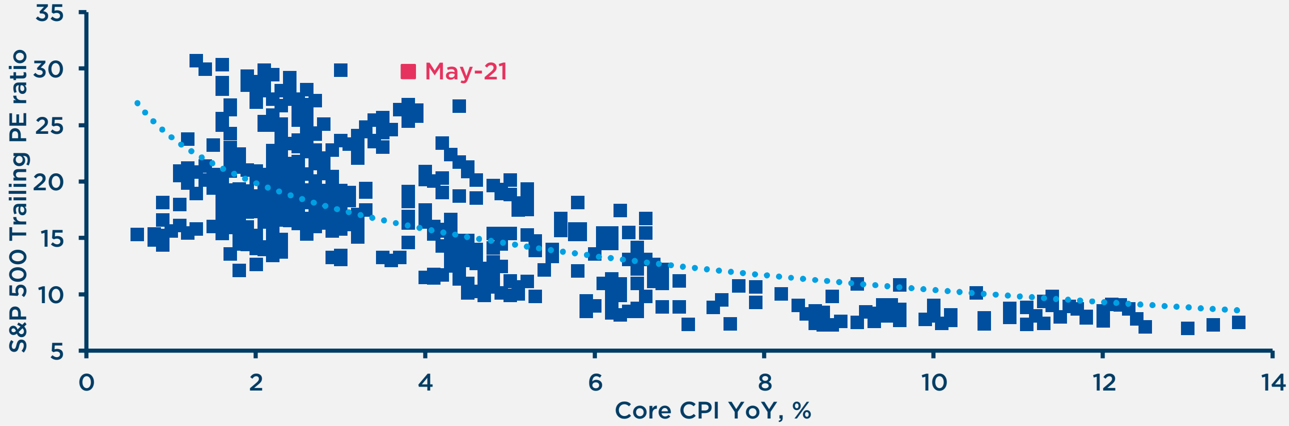
Currently, markets are priced for perfection. Both bonds and equities are expensive versus their long-term equilibrium level.

On the bond side, the secular stagnation narrative is the only one that can justify stretched bond valuations otherwise we should assume that yields will rise further.
On the equity front, valuations are in excess of what the long-term expectations for earnings can justify unless we embrace the "roaring 20s" narrative of higher productivity growth, reflecting the one experienced at the beginning of the last century. If this is not the case, as we believe, a pause in equity growth is expected. Higher inflation also challenges high market valuations (see the chart below).

Markets are pricing a Goldilocks environment with temporary inflation and lasting higher potential growth. We could be left with the opposite situation, stagflation, with structurally higher inflation and lower growth.

Market direction ahead will depend on how much further we have to go in terms of the peak in economic activity and how much of the temporary bounce in growth and inflation will become structural. Currently, there is growing evidence that companies are passing on price pressures and that consumers are continuing to buy as the economy fully reopens. In addition, the mantra of overcapacity all around (too much of everything) is a thing of the past: scarcity is coming across as a theme driving inflation higher. In the end, structural is just something temporary that has lasted. Fear of inflation can become inflation: if the rush to buy and the move to increase prices continues, they will prolong the inflation uptrend, forcing the Fed to act.

Higher inflation can be a challenge for expensive equity valuations



Source: Amundi, Bloomberg. Data as at 11 June 2021.

The Fed is walking a tight rope

The big questions in the market are how and when the Federal Reserve (Fed) will start tapering and/or increase rates and what, effectively, is an average inflation approach (especially after 10 years of below-target inflation).

The Fed will certainly try to keep rates as low as possible for as long as it can. The recovery is built on a huge debt pile and the system should hold as long as liquidity remains ample and the cost of debt does not increase too much.

A controlled increase in bond yields as a consequence of economic growth is good, but if inflation gets out of control and rates rise while growth falters, that would have nasty consequences on most indebted areas and affect market sentiment overall.

Given the leads and lags in monetary transmission, there is little room for mistake.

The Fed has to reassure the market that inflation control is a target and that it will be addressed at some point (leaving no room for an inflation spiral to be triggered), but also dismiss worries of a too-fast-and-too-early tightening of financial conditions that would risk derailing the recovery in action. The loss of control of the yield curve is a rising risk at this stage.

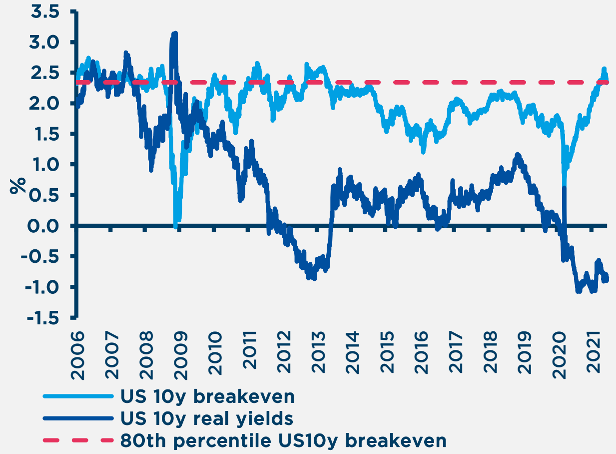
Markets are stuck in the middle. Equity markets reached a high in early June. Inflation breakevens have also factored in higher inflation, while US Treasuries have continued to trade in the 1.45-1.7 range, also thanks to supply and demand imbalances.

So, all in all, things are still pretty much under control. From here, we expect higher uncertainty as we pass through a couple of months of base effects, job market health becomes clearer and we can start assessing how temporary the inflation rise is. There will be a summer test for markets and the more we move towards it, the more markets will become nervous and volatile. In the short term, given the tight valuations in some areas of the market, a pause in the bull trend is due to readjust valuations and understand the earnings path on a case-by-case basis.

Markets will have to walk the inflation journey, with real yields being the key variable to watch.

We are approaching the end of the first leg on the road to a peak, characterised by strong rotations. We are now entering leg two, the peak phase. This is still relatively positive for investors as inflation is not seen as a threat to growth but a complement to reviving economies, but the more we advance into this phase, the higher the risk of nasty surprises. The next leg will be about what is left of the peak (most likely not the Goldilocks regime markets are currently pricing in).

US breakeven rate and real yield



Source: Amundi, Bloomberg. Data as of 14 May 2021.

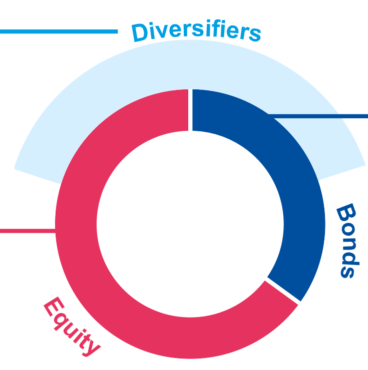
The need to reinvent the balanced allocation

Higher inflation challenges traditional diversification, as correlation between equity and bonds turns positive.

This comes at a time of lower expected returns for a traditional balanced portfolio as the contribution of the fixed income component, in terms of performance, will likely be very little. Hence, investors should structurally increase equity exposure through an inflation lens, and build more diversified portfolios, beyond the traditional benchmark allocation, including real, alternative and higher yielding assets (i.e. EM bonds). In doing this, investors will have to consider three dimensions: risk, return and liquidity.

Focus on equities, rethink the bond engine and diversify differently.

Rethinking the 60/40 portfolio construction in an era of regime shift towards higher inflation



Include real and alternative assets

- These assets should help enhance the risk return profile of the overall portfolio, crucial as a higher equity allocation will raise risk overall.

Equities are structurally a must have in a world of lower returns

- Equities as a proxy for real assets, playing the growth to value rotation as a multi-year trend.
- Factor in inflation risk and better diversify equity exposure in this respect: EM, dividend, short duration stocks, value.

Bonds beyond benchmarks

- Traditional bond benchmarks face a duration problem (high duration with low yields).
- Investors should consider unconstrained strategies to search for opportunities across the board.
- Core bonds may only be relevant for liquidity purposes.
- Positioning: short duration stance with some flexibility.

Source: Amundi, As of 30 April 2021.

Monica
DEFEND
Global Head of
Research

> *A policy mistake, in our view, is the foremost risk in the months to come while Producer Price Index is the key sentinel to look at.*

IN FOCUS: THE UNBALANCED NATURE OF THE RECOVERY

Short-term support to risk assets, but with caution

The global recovery continues to expand emphasising its uneven and increasingly multi-speed features.

We expect global GDP to reach approximately 6.5% in 2021 and converge to 4% in 2022. The growth premium between EM and DM is narrowing not only because has growth already peaked in China, but also because most of the big economies in the EM space (namely India and Brazil) are still in the grip of the pandemic. The US has been leading and is at a climax while the Euro Area has lagged and will experience its economic momentum peak in Q3 2021, thanks to the vaccine rollout and the tourism season that we expect to eventually endorse peripheral countries.

With respect to our 2021 outlook, we now emphasise the unbalanced nature of the recovery. In fact, while the first leg of the recovery has been supply driven, with policy boosters at play to rescue and relieve economies, we are now noticing the second leg being primarily demand driven. We acknowledge that consumer confidence has not fully recovered yet, due to the fragmentation of the labour market and worries about job security once government benefits expire.

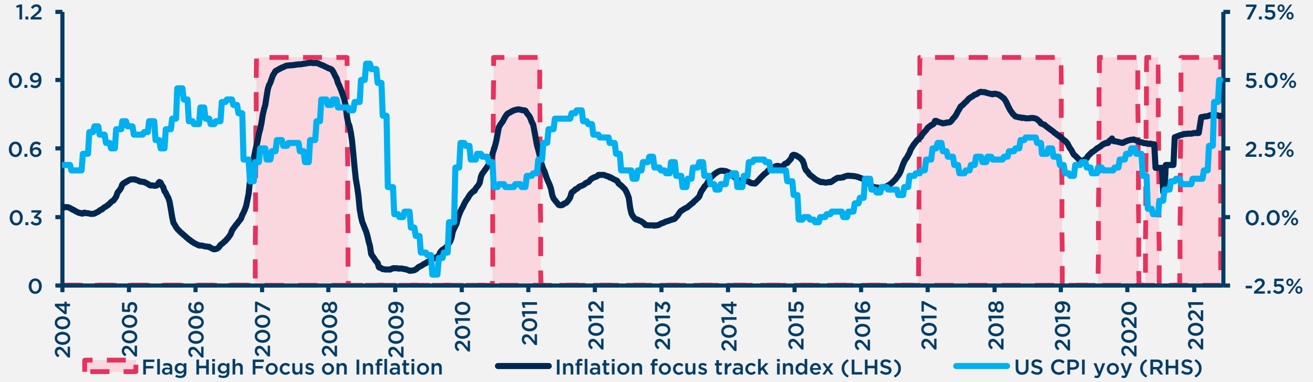
Friction between demand and supply dynamics, underpinned by supply chain bottlenecks, should be “temporarily extended”. We expect supply chain constraints to worsen over the next six months as more economies reopen (2022-2023). Moreover, as expected, consumer behaviour has been changing over the last year. We believe evidence is still too feeble to assess whether those changes in habits are going to be structural and will eventually result in higher inflation volatility ahead.

These conditions allow inflation prints to pick up and seal the end of the great moderation and suggest investors should start assessing what this means for asset classes and portfolio construction.
Higher inflation has an impact on valuations.
Historically, valuation metrics and PEs in particular, have a close link to inflation regimes. With inflation remaining below 3% and price dynamics on an upward trend from depressed levels, PE ratios decrease.

Risk assets benefit from inflation normalising from low to higher levels, particularly as a result of improved macro and micro fundamentals. Negative real rates offer further support. Historically, credit performs best in such a regime underpinned by economic growth and the risk appetite of markets. Equity returns are at their highest with inflation at 2-3%, as a healthy pace of growth and accommodative Central Banks support a risk-on market stance for financial markets. On the risk front, inflation creeping structurally beyond 3% would be progressively detrimental to risky assets.

Over the medium term, we expect lower cross asset returns, particularly when compared to past recoveries due to current extreme valuations and market levels.
Short term, markets have largely priced in inflation expectations and the focus is now on Central Banks where the Fed remains rather uniform, while the ECB has more disperse views on the need to cool down purchases. “Holds out” rhetoric allows equity market valuations to stay high, steeper curves, higher breakevens and FX volatility as currencies are the only price the Fed and ECB cannot control.

Amundi inflation focus track index signals the move towards a normal inflationary regime



Source: Amundi Research. Data as at 11 June 2021.

BASE AND ALTERNATIVE SCENARIOS AND RISKS

Downside — Multi-faceted pressures — 25%

- Spread of virus variants leads to renewed lockdowns, extending the crisis through end-2021.
- Vaccine side effects or lasting shortages hits global confidence and growth.
- Pro-cyclical US fiscal policy de-anchors inflation expectations and leads to a rise in interest rates and USD impairing financial stability.
- Slower China growth spills over to DM economies.
- Eurozone cannot enhance its recovery, with a few countries falling into stagflation.

Central scenario — Multi-speed recovery — 60%

- Massive vaccine rollout, uneven across regions and multi-speed recoveries across regions: stronger in the United States and Europe, weaker in EM.
- Growth momentum pauses, temporary inflation spike.
- Loose policy mix boosts the recovery and helps stabilise debt-to-GDP ratios.
- Political commitment mobilises fiscal policies in DM, but execution could be diluted in the EU.
- Positive earnings momentum, receding solvency risk.

Upside — Sustainable & inclusive recovery — 15%

- Mass vaccination campaign fixes the health crisis by mid-2021, enabling a full global recovery.
- Shrinking uncertainty allows the service sector to catch up with manufacturing.
- Quick recovery in the US labour market may cause rising wage pressures.
- Extra savings feed into stronger private consumption, starting a virtuous cycle with no overheating in sight.
- Medium-term productivity gains from new digital and green developments.

The wall of risks

High — Probability — Low

	20%	20%	15%	15%	10%
Risk	Policy mistakes	De-anchoring rates and inflation expectations	Frictions redesign the political board (US/China/EU /Russia)	Corporate defaults lead to financial instability	Uneven vaccine rollout, out-of-control outbreaks (medium-term)
+	Positive for cash, linkers, JPY, Gold, USD, Defensives vs. Cyclicals	Positive for TIPS, USD, gold, equities, value, cyclicals	Positive for USD, JPY, UST	Positive for USD, DM sovereign bonds, gold	Positive for cash, USD, UST
-	Negative for oil, risky assets, AUD CAD or NZD, EM local CCY exporters	Negative for long-term UST, Bund, EM fixed income, global FX	Risk on HK peg. Negative for Chinese equities, CNY	Negative for risky assets, low-rated credit, liquidity instruments	Negative for risky assets

Source: Amundi as of 15 June 2021. DM: developed markets. EM: emerging markets. USD: US dollar. JPY: Japanese yen. CNY: Chinese yuan. CHF: Swiss franc. UST: US Treasury. TIPS. Treasury inflation-protected securities. CAD: Canadian dollar. NXD: New Zealand dollar, CCY: currencies.

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AMUNDI Investment Insights Unit

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In a world in which investors are exposed to information from multiple sources we aim to provide regular, clear, timely, engaging and relevant insights that we believe can help our clients make informed investment decisions.

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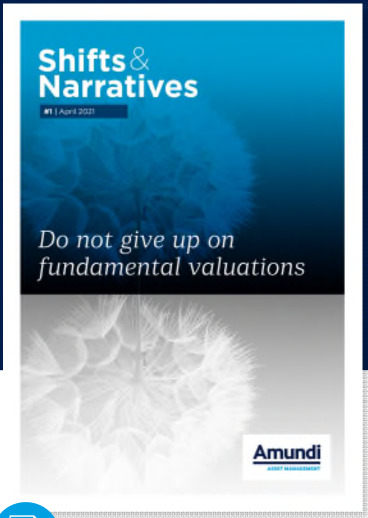

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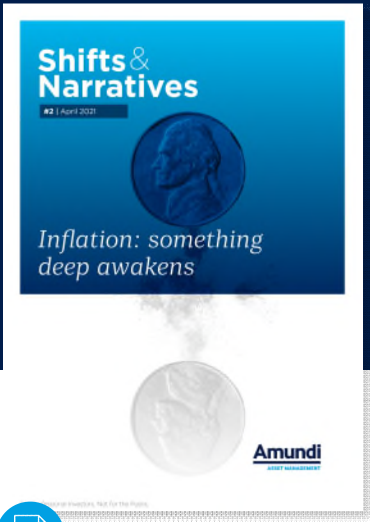

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