THIS MONTH'S TOPIC

Q3 2021: From a recovery phase to an inflationary late cycle

- **A second derivative stagflationary environment of decelerating growth amid sustained inflationary pressures. The fiscal lever continues to play a pivotal role.**
- **This translates into moderate equity exposure with a tilt towards value and quality sectors. Interest rates on IG is preferred to govies, with linkers offering a hedge.**

Lorenzo PORTELLI,
Head of Cross Asset Research

Silvia DI SILVIO,
Cross Asset Research Macro Strategist

Annalisa USARDI,
Cross Asset Research Senior Macro Strategist

Lower growth, higher inflation and moderate risk exposure is expected for 2022 as a central scenario

1. A second derivative stagflationary environment of decelerating growth amid sustained inflationary pressures

The Global Growth outlook in recent months has deteriorated in several factors, culminating in the downgrade of expected growth in China and the US, among others.

In China, despite the relaxation of social distancing rules, a confluence of factors continues to weigh on economic recovery, including the housing slowdown and the NDRC's energy use control, posting a negative string of data, with exports being the only exception. Policy tightening with the housing slowdown, self-imposed restraints (zero-tolerance Covid-19 policies, de-carbonisation production cuts, and electricity rationing) and the global chip shortage all contributed to a weaker economic performance in Q3. For the second time in less than two months, we have downgraded our growth forecasts; we no longer expect growth to recover to trend in Q4 2021, and we have revised down our growth forecasts for 2021 and 2022.

On the US front, for the second time we have revised down our projections for US economic momentum in H2 2021, based on softer domestic demand and consumption. The increase in Delta cases and expiring of some measures supporting household income, amid higher-than-expected inflation, have generated a sharper-than-expected deceleration in domestic demand and GDP in Q3, trimming growth prospects for H2 2021, although we see signs of improving activity for Q4. **The growth premium between** DM and EM is expected to return more in favour of DM for the time being, with China spillovers weighing first on EMs with high trade and commodity exposure to China, as well as limited policy room. **The growth premium is expected to rebalance more in favour of DMs, mainly due to positive economic momentum for next year in several countries materialising on the back of new fiscal support (the US infrastructure plan and the NGEU in the Eurozone) and the prosecution of the massive vaccination campaign, which should somewhat reduce the propensity of governments to implement severe activity restrictions in case of new Covid waves.** Growth will remain multispeed, uneven and heterogeneous at global and regional levels and, crucially, will be dependent on getting the withdrawal speed of policy support right.

POLICY MIX - The fiscal lever continues to play a pivotal role in supporting the recovery, especially among advanced economies, in a context where monetary policy, while remaining broadly supportive, will have to begin a gradual normalisation process. This is particularly true in the US, where a full-sized "Build Back Better" plan would provide a significant upside risk to our growth projections, which currently encompass only what is so far included in the bipartisan deal; this also holds true for the Eurozone, where the role of NGEU-financed projects is one of the main drivers of the sustained and above-trend pace of growth we project for next years. Indeed, implementation risk is considered, but the spillovers of higher investments and structural reforms remain broadly positive, especially in supporting higher potential growth. Among **emerging markets, the policy mix looks more heterogeneous.** Broadly speaking, the EM Policy mix is relatively tighter. Monetary policy is normalising faster than anticipated on high inflation even though real rates are slowly getting to more neutral levels. In September, we increased the final policy rates for some economies (Andean and CEE mainly) or anticipated the start of hiking (Colombia). Recent Fed comments have moved slightly to a relatively more hawkish stance, although the market reaction remains gradual and benign for EMs.

INFLATION - The annual inflation outlook has been revised higher for DMs, on a combination of higher commodity and energy prices, cost pressures and, in a few countries, stronger domestic demand prospects. Much of the expected rise and overshoot of headline inflation this year has extended longer than expected. In particular, supply-side issues, compounded with higher energy and input costs (delays in logistics and increased shipment costs, to name few bottlenecks), have created a mix favourable to higher inflation persistence. Some of these factors will start to ease in mid- 2022 (e.g., supply bottlenecks) while others will tend to persist, leaving the terminal inflation rate at the end of our horizon significantly higher than prior to the crisis, in particular in the US. In this respect, we are monitoring the increase in consumer and market inflation expectations and their implications for second-round effects and wage settings. Yet, as of now, the stabilisation of core inflation above the central banks' target appears to be more a US-

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specific case. In the Eurozone, it is still unclear how the withdrawal of furlough schemes and labour support measure will play out in terms of labour market slack and wage growth.

Among EMs, in August headline inflation has generally remained high relative to the central banks' desired levels. Cost pressure continued in September. Still, Asia is keeping the most benign picture, due to more sluggish growth dynamics. In Latam, we still see the pandemic- and the global-recovery-related drivers of high inflation as mostly transitory. While strong one-offs, two-speed services and core goods inflation dynamics make high inflation clearly more robust and stickier, but the (lack of the) Phillips curve pressures will be a stabilising force, once economies reopen and normalise.

Inflationary late cycle the most likely phase with potential downside risks

Medium-term investment outlook

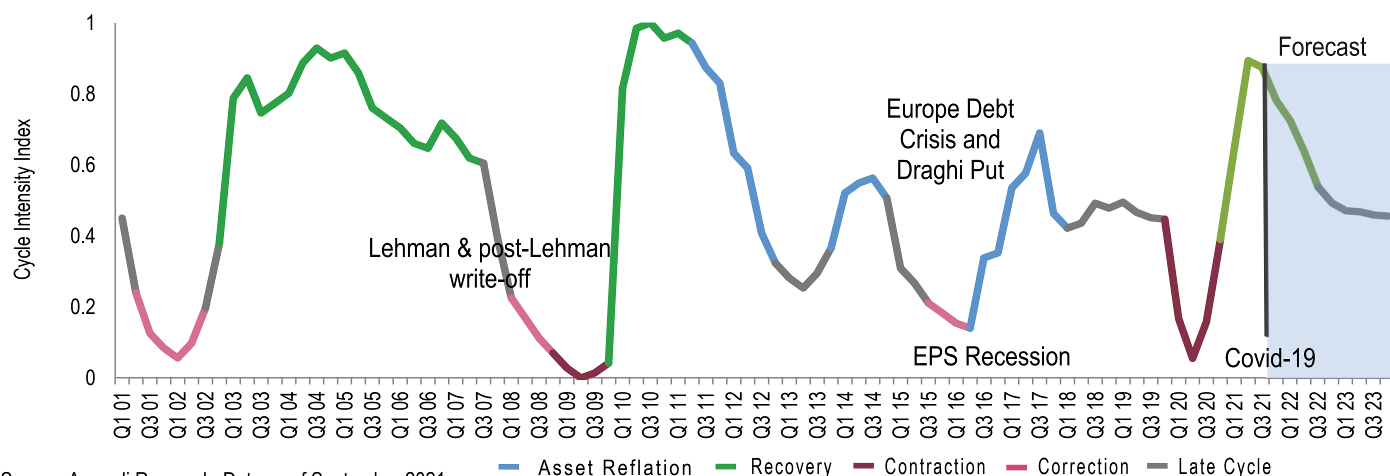
On a 12 months horizon, the current macro-financial backdrop calls for a continuation of the ongoing *recovery* phase through H1 2022. Starting from Q3 2022, the *late-cycle* regime will become likelier and develop into the predominant one from Q4 2022 and for the remainder of our forecasting horizon, in 2023.

Until the first half of 2022 the recovery phase will still be supported by:

- the **strong** (albeit decelerating) **pace of economic growth** expected for the current year and the first half of next one, also boosted in some areas (US and EU) by very supportive fiscal policy;
- **inflation** remaining **above trend** (due to both supply and demand dynamics);
- global EPS cycle to deliver solid growth, thanks to the still elevated level of economic activity;
- extremely accommodative financial conditions.

Starting from the second half of 2022 and into 2023, the cycle is expected to lose traction and transition into the so-called *late cycle.* Growth approaching trend levels, inflation decelerating from 2021-early 2022 peaks, monetary policy turning less accommodative in some DMs (namely the US and UK) and EM countries and the resulting tightening in financial conditions from the current record easy levels, will all contribute to the economic regime shift, with inevitable consequences on financial assets.

1/ **Advanced Investment Phazer Regimes occurrences since 2001**



Source: Amundi Research. Data as of September 2021.

2. Investment consequences: late cycle less benign for risky assets, due to inflation scare

The late cycle has historically been a phase where risky assets have delivered positive returns. This time it should be less supportive, due to higher inflation than normal, Fed tapering, and absolute and relative value considerations. For the first time since 2007, margins are vulnerable to rising production costs, due to supply disruption and bottlenecks. The top line is likely to remain solid enough for preventing profit recessions, but downside risks are not negligible and visibility is quite low. As a consequence, a conservative asset allocation has been confirmed in the near term and the tilt in favour of asset classes, positively impacted by rising prices, should be favoured in equities, FI and FX. US inflation linkers are the natural candidates in govies despite looking a bit stretched after the recent rally; IG (mainly in Europe) should guarantee positive carry at reasonable risk. Decelerating growth and margin-squeeze concerns are driving focus more on the sustainability of quality business models in the value segment rather than specific regional equities exposure. Despite decelerating growth towards trend levels, inflation scares will lift rates higher, in line with long-term inflation expectations putting some pressure on central banks.

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US inflation

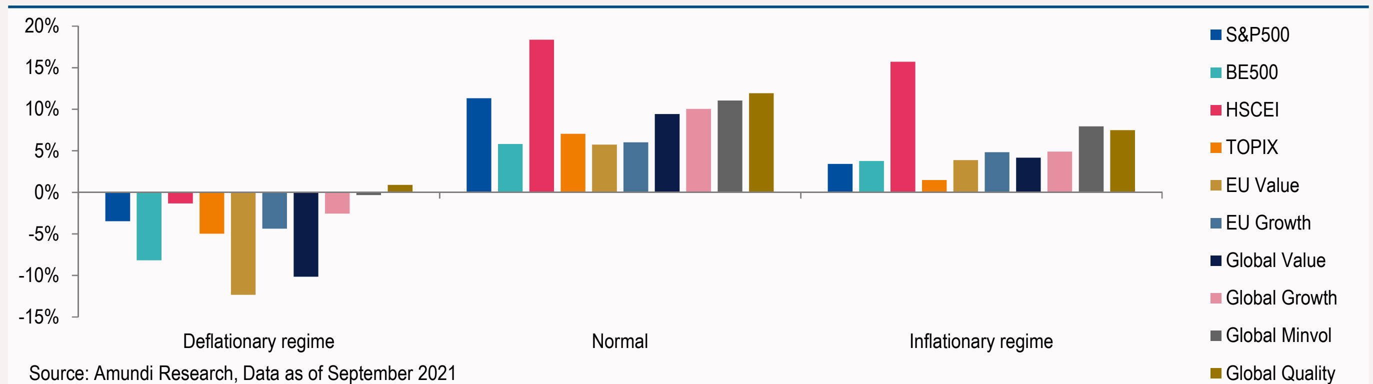
Looking at the next 12-18 months, **a dynamic mix of factors will continue to drive inflation in the US as price pressures broaden out to stickier and more persistent components,** with implications for pipeline cost pressure and PPI, for headline and core inflation pass-through and ultimately for inflation expectations and labour costs.

- Over the course of next year several base effects that held inflation depressed in 2020 and, conversely, supported inflation in 2021, will drop in a year-over-year comparison, generating a noticeable transition in mid-2022 to lower levels of headline inflation. **These levels will, anyhow, be significantly higher than pre-crisis ones, due to higher levels of core inflation.**
- **More "structural" forces will take the lead in defining the core inflation trend: wage dynamics,** which we expect to pick-up as the labour market tightens further, **and rental growth,** which we expect to grind higher till early 2022 at least.
- **We also have to acknowledge that, although somewhat decelerating, demand, in particular for core goods, remains strong and above its pre-crisis trend, keeping prices supported as supply remains constrained;** while we assume bottlenecks will begin to be resolved in 2022, thus reducing pipeline pressures, core goods prices will remain supported above their usual trends also during the first half of next year.
- **On the near-term (upside) risks, we also have to mention the possible pickup in travel-related pricing of some core services** (which we assume will take place in the holiday season, given the decline in Delta cases and the expected resumption in travel).

We gauge a measure of what inflation regime can be expected over the forecast horizon leveraging on *Amundi's Inflation Phazer*. The expected pattern of the US price indices included in the tool implies that CPI, PPI and Core PCE will register a YoY level in line (or even above in PPI's case) with the *Inflation* regime band (3-6%) at the end of 2021. Consequently, the Inflation Phazer assigns the highest probability to such a regime for the current year. In 2022 and 2023, as all three of the aforementioned indicators are expected to decelerate and stabilise within the *Normal* regime range (2-3%), the Phazer is accordingly giving the highest probability to such a regime for both years. Looking at the overall distribution of probabilities, a relevant aspect is also represented by the evolution of the two *hyperinflationary* regimes. Their aggregated probability indeed spikes from 10% (the average level at which hyperinflation risks are very low) up to a range of 30-35% in the second half of 2021. It is interesting to notice an analogous juncture in 2008, when the *inflation* regime was paired with a similar risk of *hyperinflation*.

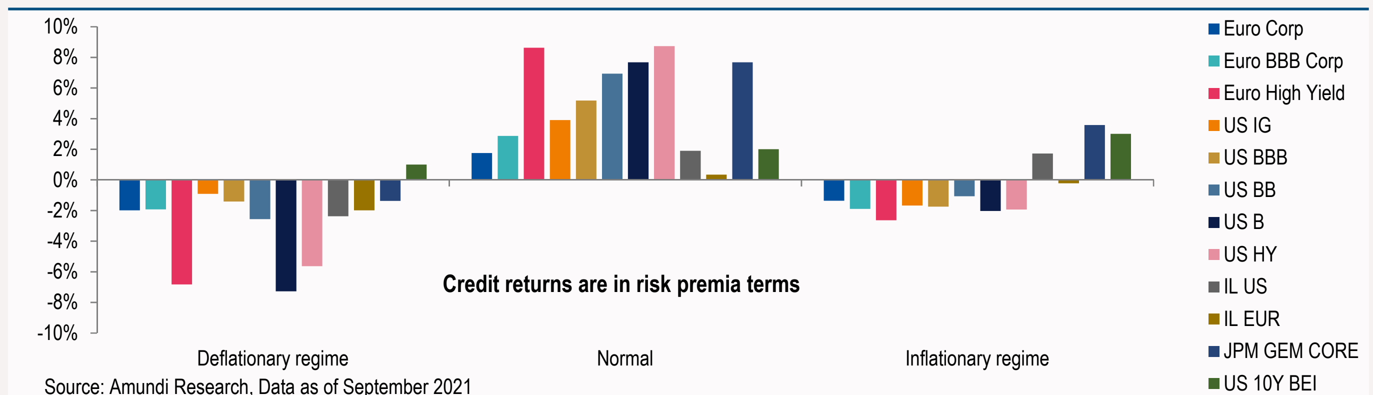
In terms of investment consequences, concerns on global deceleration's meeting rising inflation expectations translates in a progressive recalibration in the risk budgeting of our portfolios towards a reduction of the overall equity exposure, while maintaining a tilt towards value and quality sectors. Moreover, under the "*Inflation*" regime, monetary policy is expected to undertake a normalisation path. Such a context is less supportive than the "Normal" one for risky assets. As interest rates rise, equity is preferred to credit, with inflation-linked bonds offering a hedge.

2/ Equity performance (Total return)



Source: Amundi Research, Data as of September 2021

3/ Credit and inflation linked performance (Total return)



Source: Amundi Research, Data as of September 2021

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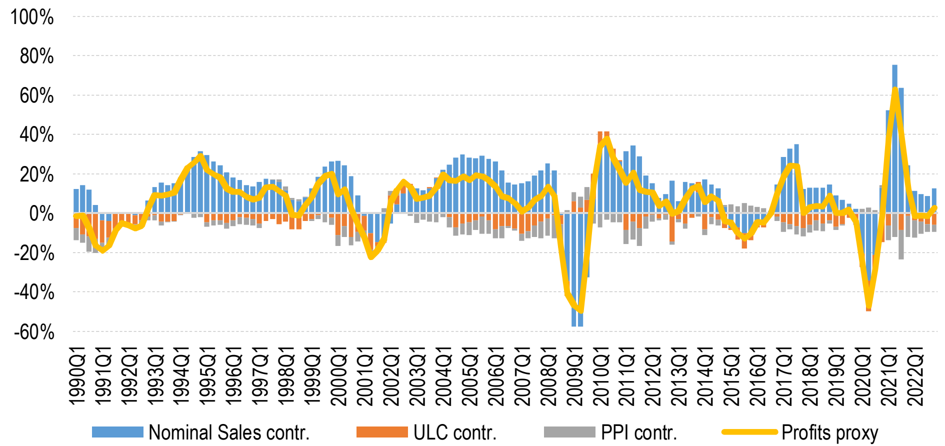
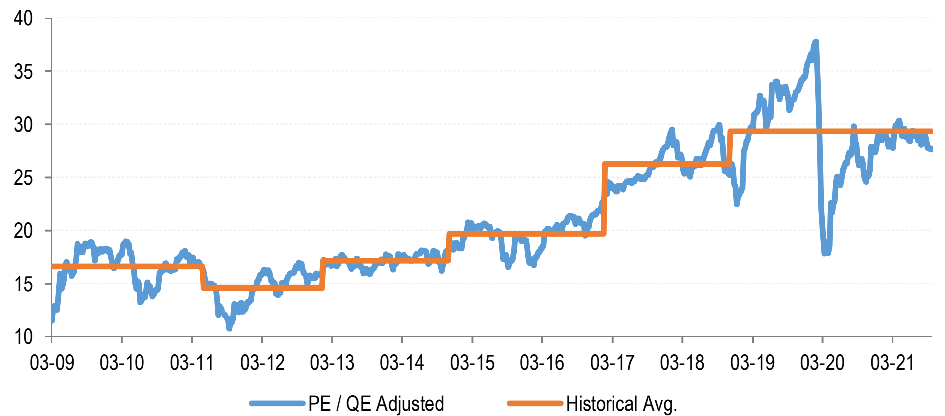
4/ Profits margins are vulnerable to rising production costs and supply disruptions this time
Top & Bottom Line: YoY Contributions



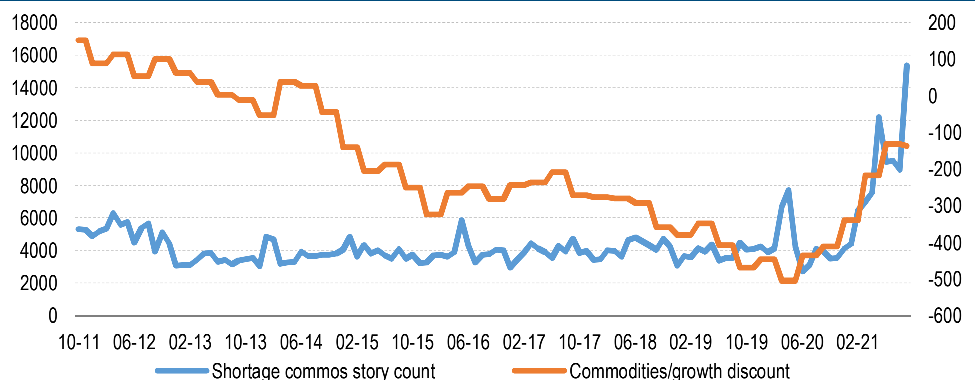
Source: Bloomberg, Amundi Research calculation. Data as of October 19, 2021.
Methodological note: Profit proxy is calculated as Top line (Nominal Sales YoY Contribution) –Bottom Line (Unit Labour cost YoY and PPI YoY contributions)

5/ Unlikely to see higher multiples from current levels going forward, even liquidity-adjusted multiples
S&P 500 PE Adjusted for Fed balance sheet expansion



Source: Bloomberg, Amundi Research calculation. Data as of October 19, 2021.
Methodological note: S&P500 PE is the time weighted average of current and next year PE. These PEs are then adjusted (ratio) for a liquidity multiplier: FED Total Asset Balance Sheet (rebased to 1 at the beginning of QE in March 2009).
The historical average is dynamic and considers historical breaks to reflect monetary and economic regimes changes.

6/ Shortage narrative is driving commodities prices higher, notwithstanding decelerating growth
Commodities valuation vs shortage narrative



Source: Bloomberg, Amundi Research calculation. Data as of October 19, 2021.
Methodological note: Commodities/growth discount is calculated as difference of global commodities price and blended basket index (World OECD Leading ind.+ US nom gdp, rebased jun-1961). "Shortage narrative" is calculated through BLG News trend tool on "Shortage" AND "Commodities" words.

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Tapering and profits deceleration not in favour of expansion in multiples

Fed monetary policy and unconventional tools for pumping extraordinary amounts of liquidity provided formidable support to the 2021 equity rally, besides the strong rebound in profits and economy. Liquidity-adjusted valuation metrics have been in cheap territory with few exceptions so far. Although the Fed is expected to remaining dovish and monetary policy accommodative going forward, the tapering process should reduce liquidity propellant to the markets while the deceleration in EPSs should mitigate investors' complacency. As a result, multiples should barely expand in 2022, if any they should contract. For the time being profits growth should be strong enough to deliver positive returns although all risks (rates, productions costs, margins and new Covid variants) are all skewed on the downside.

Reality check on the continuation and sustainability of the commodities rally

After several years of depressed valuations and being a laggard in this bull market, global commodities are benefiting from an exceptional combination of positive factors: the ongoing recovery-driven boost in demand while the green transition and Covid issues generate short-term bottlenecks, supply disruptions and long-term pressure on commodities necessary for the green conversion. As a consequence, commodities have been one of the best performers in the latest month, and they are expected to be quite resilient going forward. Seasonal factors will exacerbate the energy shortage in Q4 21 and Q1 22, and current levels for natural gas and oil will last for a while. Commodities hence should be the favourite asset class in a balance portfolio helping to mitigate potential drawdown from shortage-induced external shocks.

Conclusion

A second derivative stagflationary environment of decelerating growth amid sustained inflationary pressures have taken the stage, marking a shift towards a more cautious asset allocation in the near term. The Global Growth outlook in recent months has deteriorated on several factors, culminating in the downgrade of expected growth in China and the US, among others. The annual inflation outlook has been revised higher for DMs, on a combination of higher commodity and energy prices, cost pressures and, in a few countries, stronger domestic demand prospects. Starting from the second half of 2022 and into 2023, the cycle is expected to lose traction and transition into the so-called late cycle.

In terms of investment consequences, concerns on the global deceleration, combined with rising inflation expectations, translates in a progressive recalibration in the risk budgeting of our portfolios towards a reduction of overall equity exposure, while maintaining a tilt towards value and quality sectors. Moreover, under the "Inflation" regime, monetary policy is expected to undertake a normalisation path. Such a context is less supportive than the "Normal" one for risky assets: as interest rates rise, equity is preferred to credit, with inflation-linked bonds offering a hedge.

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CARULLA POL, *Amundi Investment Insights Unit*
FIOROT Laura, *Deputy Head of Amundi Investment Insights Unit*
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