June 2021

The inflation moment

Strategies to protect portfolios from inflation risk

Investment Insights | Market Stories

Confidence must be earned

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Prepare portfolios for a structurally higher inflation

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"As the global economy emerges from its worst slump since the 1930s, we envisage plenty of inflation fertilisers at stake, especially in the United States. Inflationary trends could emerge due to a combination of factors, including the cyclical recovery as countries try to get the pandemic under control and gradually lift mitigation measures. This will come at the same time as a super-sized US fiscal stimulus, supply chain bottlenecks, pent-up demand and savings, and upward pressure on wages. In addition, the infrastructure plan is likely to be passed by the US Congress in late-2021, unfolding its impact mainly in 2022-23 and in the longer run. These trends will join forces with more structural trends and a likely regime shift towards higher inflation as a way out of the crisis, as highlighted in the paper "Don't give up on fundamental valuations". On the Fed's side, the central bank has been insisting that inflationary pressures are transitory, but at the end structural is just something temporary which has lasted for sometime. And investors should be ready for this!

Higher inflation will have huge investment implications and any portfolio construction exercise should be approached with this regime shift in mind. In bonds, upward direction of rates (non-linear) and inflation warrant a more cautious and active stance on duration, while searching for income across the entire market spectrum with a global unconstrained approach. In equities, where we are risk neutral for now, given the high valuations in some segments and some pause in momentum, higher inflation may dent valuations, especially those at expensive levels. Instead, investors should favour the multi-year rotation from growth to value stocks both in the United States and Europe. Equities exposed to resources and infrastructure as well as high dividend stocks could be interesting in an higher inflationary regime. On the contrary, caution is needed towards rate-sensitive – high duration stocks. At a cross-asset level, higher inflation will challenge traditional portfolio diversification, as the equity-bond correlation turns positive. Solutions that target real returns with a broad range of asset classes will be attractive in this respect."

01

Inflation fertilisers at stake

Main inflationary trends

1 Cyclical recovery after the peak?

China passed its peak of acceleration. US is likely to peak in Q2, while Europe will lag by a quarter. Service and consumption are likely to offset some manufacturing cool down. Beyond the peak, we could see some deceleration and no structural shift towards higher growth.

2 Fiscal stimulus

The US continues on its stimulus spending with Joe Biden's latest proposal to spend around $4.5tn on infrastructure, education and childcare. While the plan claims to boost the country's long term productivity, it may create additional inflationary pressures.

3 Pent-up demand

Once the pandemic gets under control and restrictions are lifted, pent-up demand could unfold in those sectors which have been hit the most by lockdowns (e.g., travel, leisure, entertainment, eating out), causing inflation to accelerate.

4 Seeds for a regime shift

For the first time in over 30 years, market narratives are expressing a preference for inflation as a way out of the crisis and of the huge amount of debt accumulated. This will have key implications on long-term trends.

Next 12-24 months (1–3)

3-5 years (4)

Source: Amundi as of 31 May 2021.

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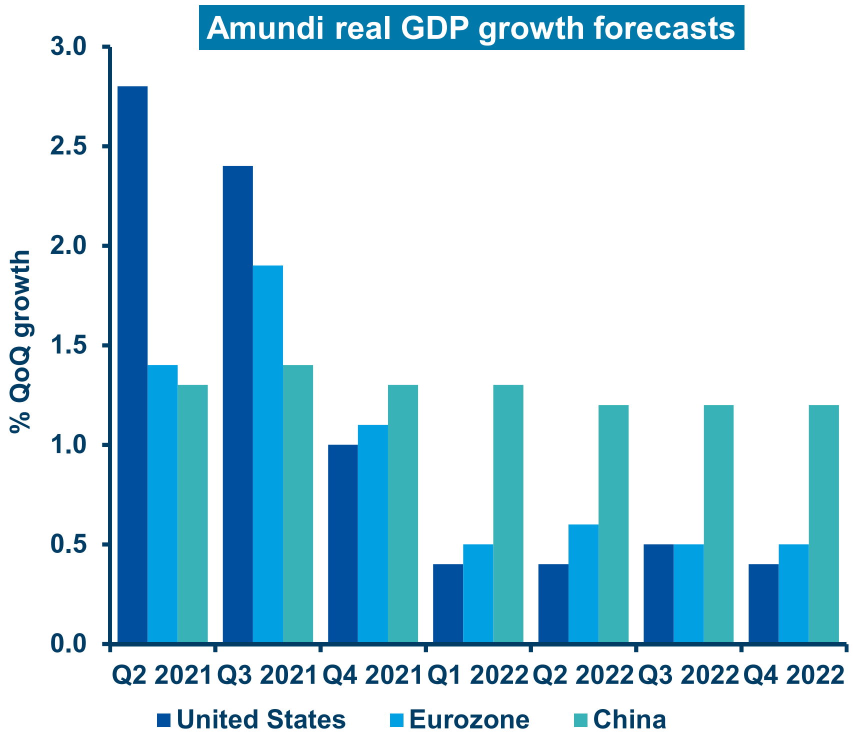
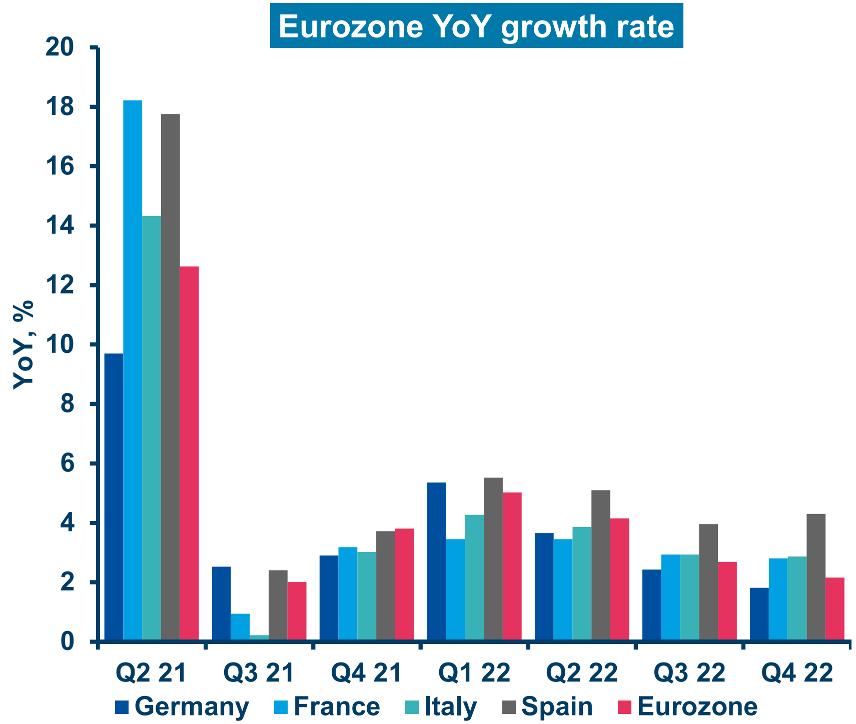
US growth likely to peak in Q2, Eurozone in Q3





US fiscal packages and Biden's drive to spend should support the country's economic growth, even after the GDP growth peaks in Q2. For the Eurozone, we expect a sharp bounce in Q2 and and a peak in Q3.

Source: Amundi Research. Data as of 25 May 2021. Forecasts are by Amundi Research.

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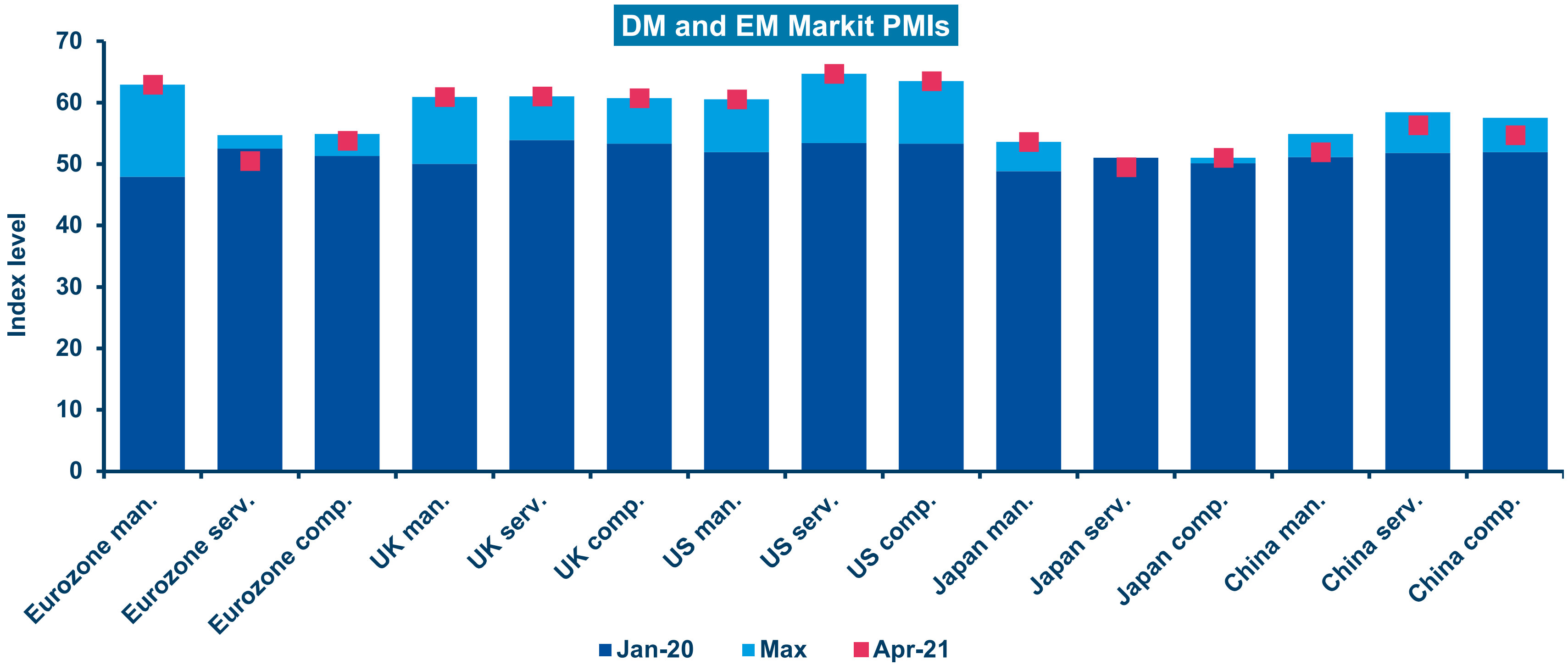
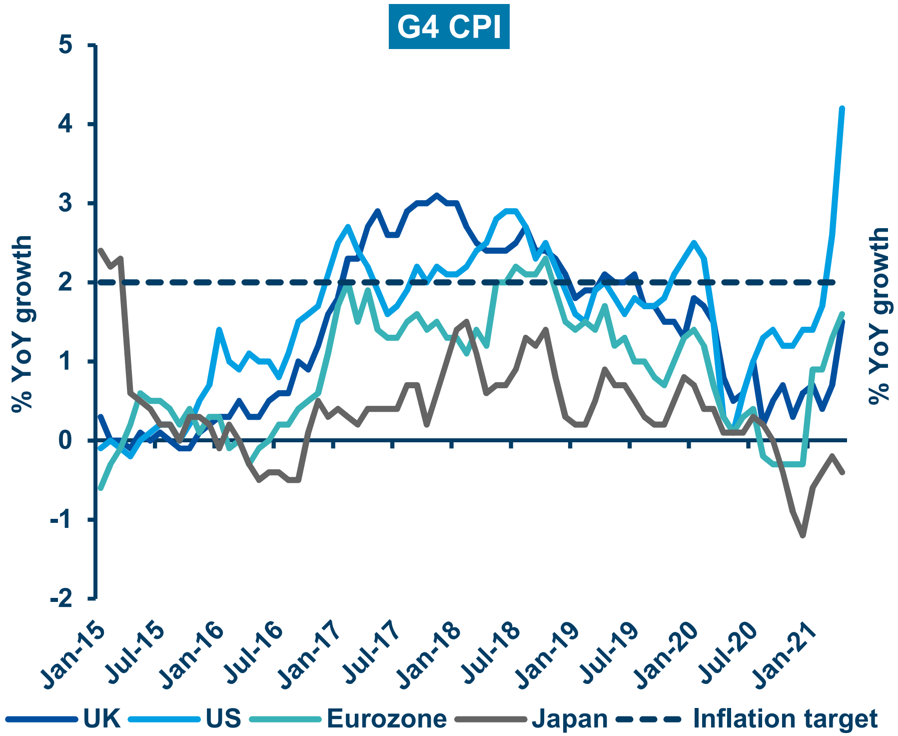
PMIs mostly above pre-Covid-19 levels, close to the peak

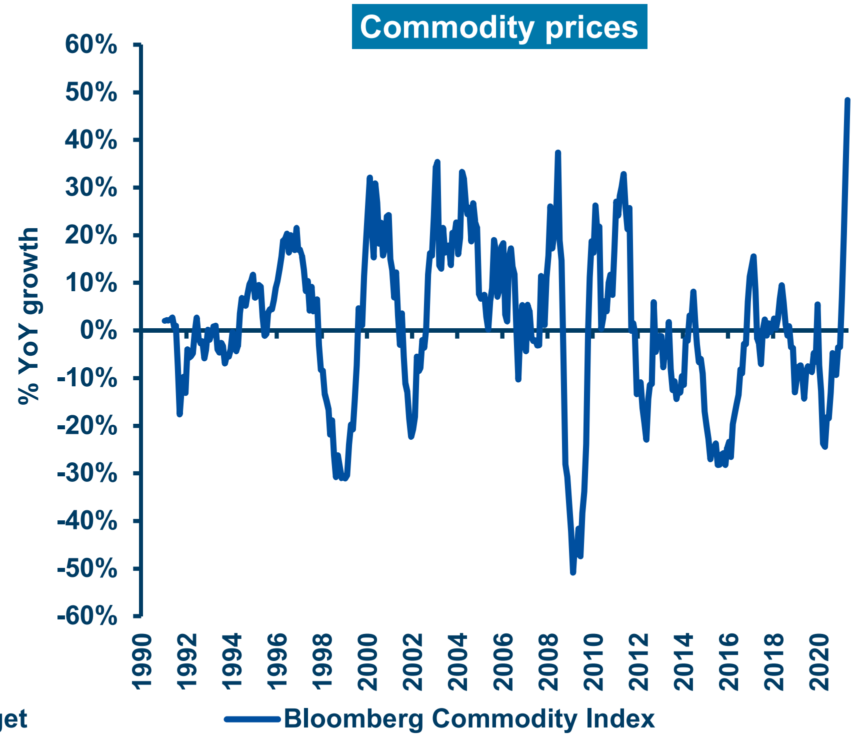


Manufacturing and services PMIs are mostly back above their pre-Covid-19 levels across main DM and EM and close to their highest levels since January 2020. This bodes well for recovery prospects in the second half of this year, as restrictions are gradually lifted. However, markets will start questioning how far the rebound can go.

Source: Amundi. Data as of 25 May 2021. PMI: Purchasing Managers Index.

The inflation moment has already arrived in the United States



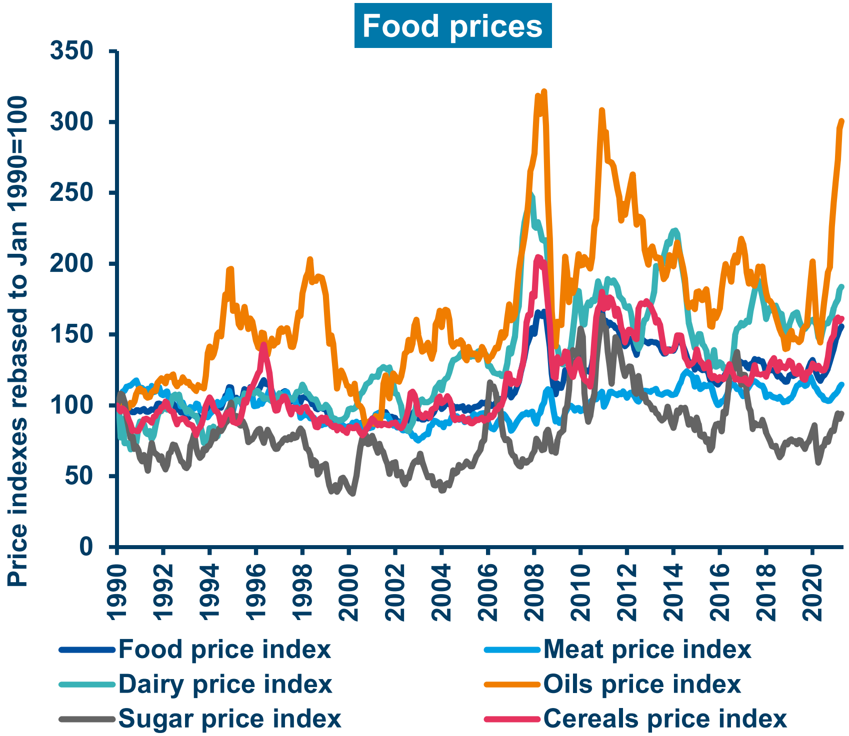


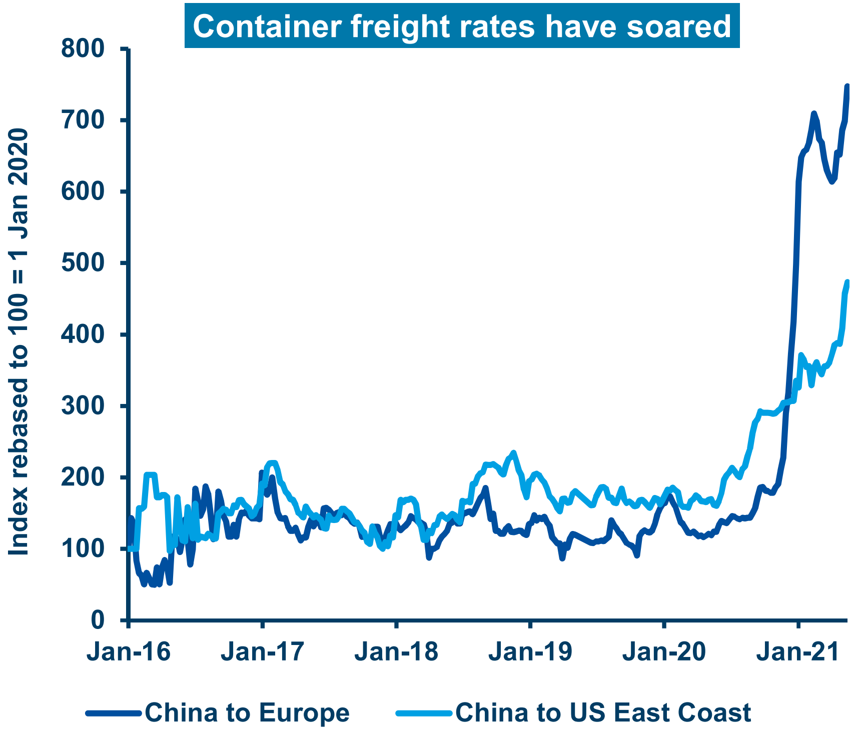
Inflation is on the rise, driven by base effects, accelerating demand and supply-chain bottlenecks. Uncertainty remains on the legacy of such an inflation surprise, on how transitory it will be and when the Fed might react. We believe in a structural shift towards higher inflation. Such risk is underestimated by markets, while above-potential growth may be overestimated.

Source: Amundi, Bloomberg. Data as of 24 May 2021.

Source: Amundi, Bloomberg. Data as of 24 May 2021.

Price pressures building everywhere



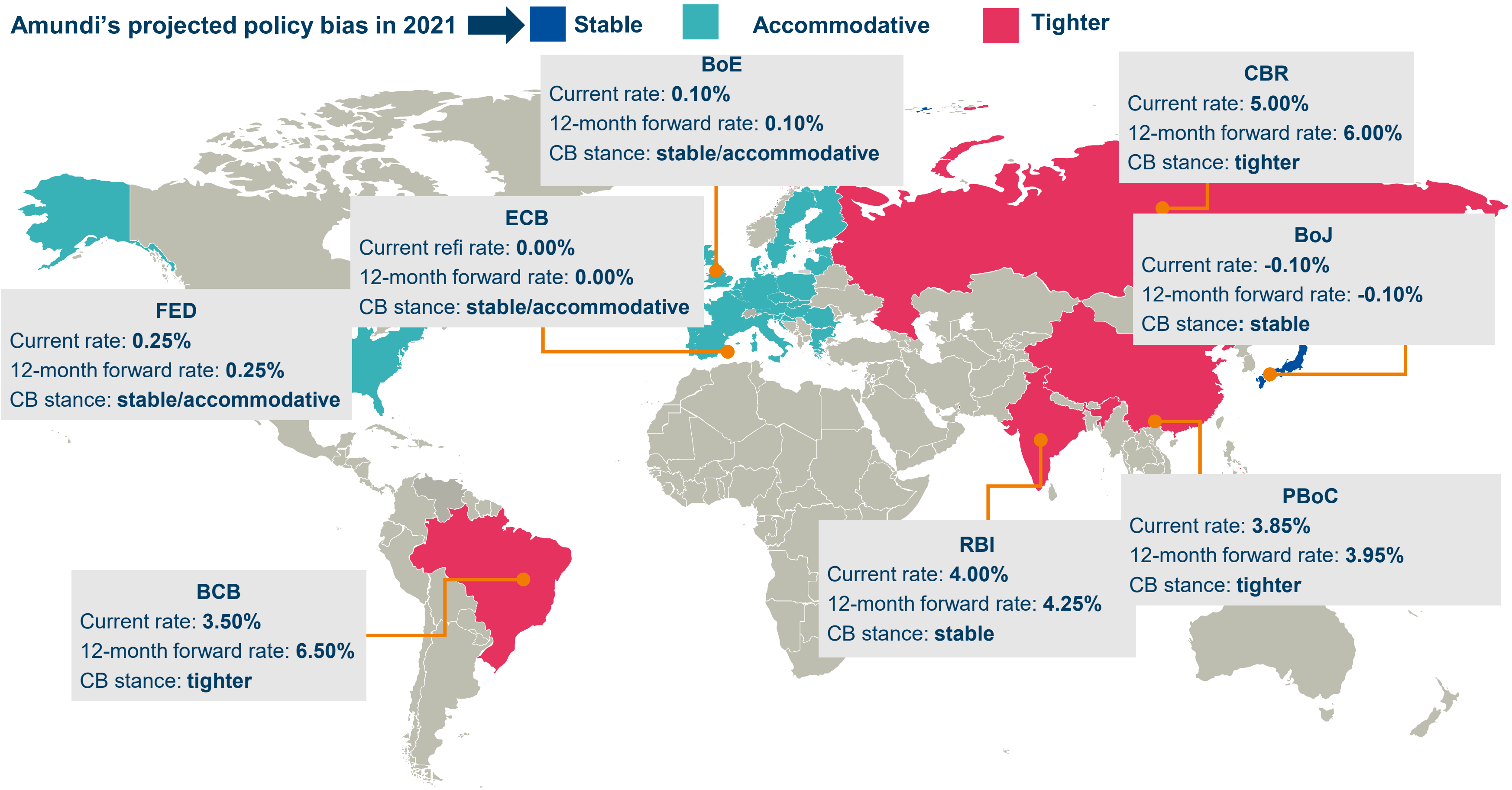


Food inflation has risen and is driving inflation in countries where the food import bill is relevant. In most EM, food represents a large share of the inflation basket. The cost of shipping goods from China to Europe and the United States has ballooned, since January 2020, due to a combination of container shortages and recovering consumer demand.

Source: Amundi, FAO. Data as of 24 May 2021.

Source: Amundi, Bloomberg. Data as of 28 May 2021.

DM central banks will let the music play on



Source: Amundi Research as of 26 May 2021. Illustrative map for monetary policies. Central bank stance refers to expected changes on QE or unconventional tools position throughout 2021 and early 2022. Fed: Federal Reserve; BoE: Bank of England; PBoC: People's Bank of China; BoJ: Bank of Japan; BCB: Central Bank of Brazil; CBR: Central Bank of Russia; ECB: European Central Bank; RBI: Reserve Bank of India.

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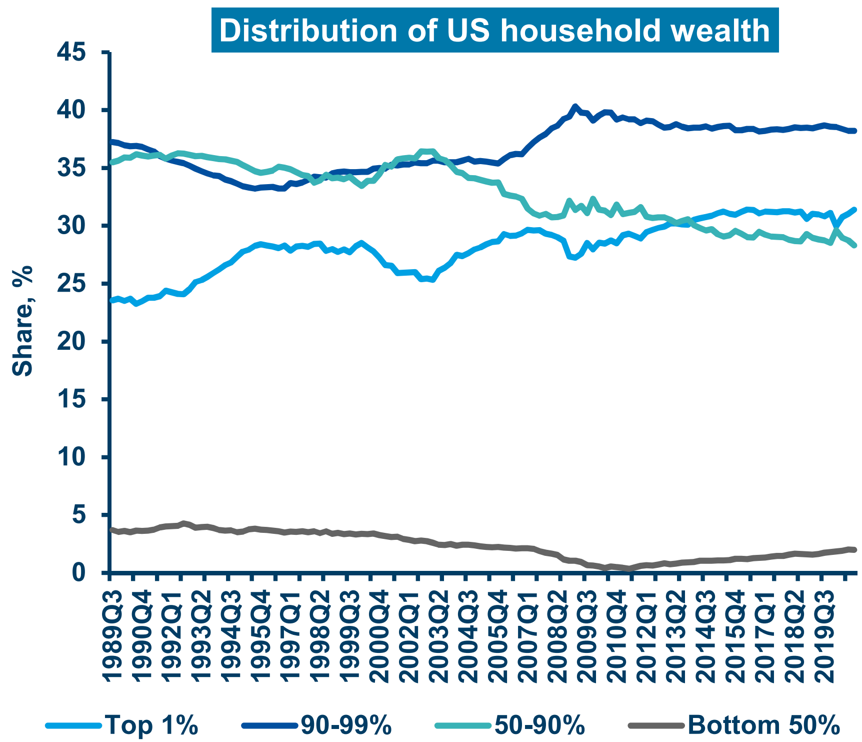
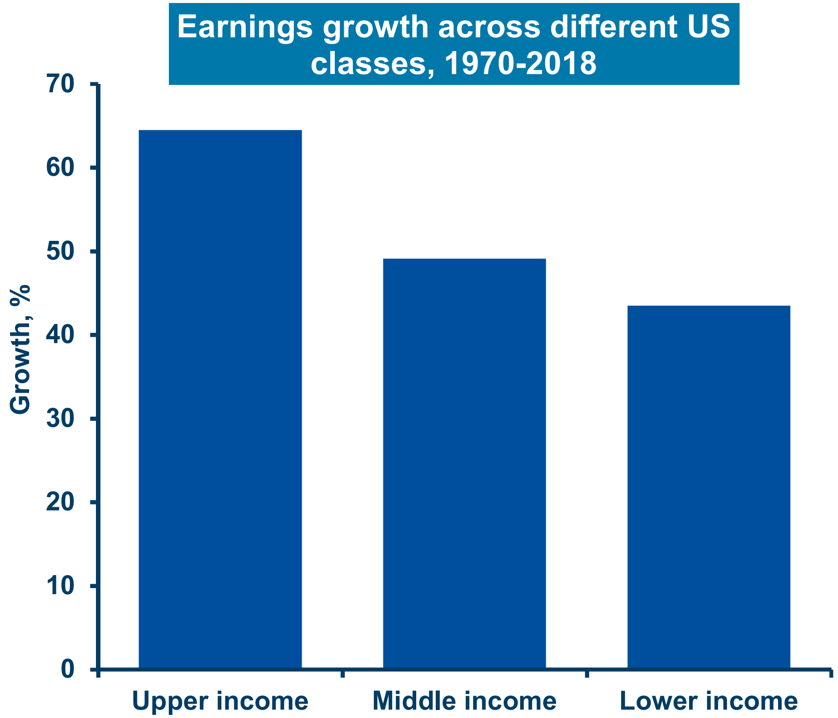
Polarised US wealth underpins the need to fight inequality





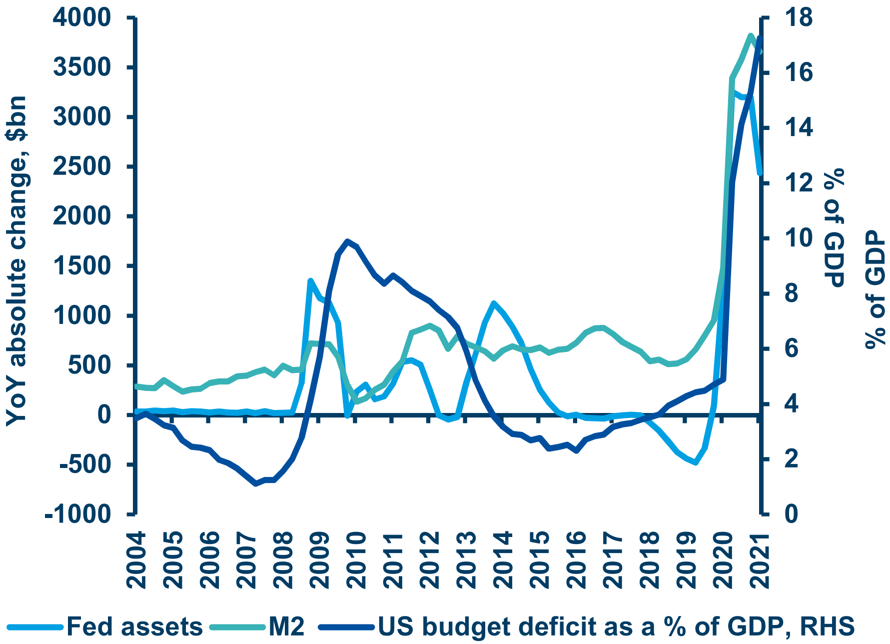
» Over the past 50 years, the highest-earning US households steadily brought in a larger share of the country's total income. The top-ten percentile has seen its share of total wealth rise from 60.8% in 1989 to 69.3% in Q3 2020, while the bottom 50% has seen its share decline from 3.7% to just 2.0% over the same period. Earnings growth is faster for upper income earners compared with lower- and middle-income ones.

Source: Federal Reserve as of September 2020.

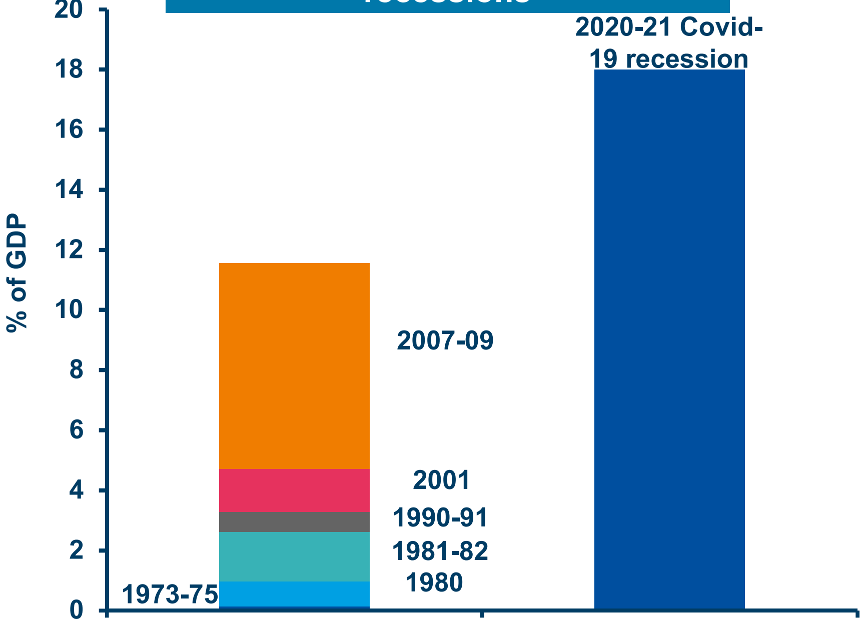
Source: Pew Research Center as of February 2020,

The fiscal expansion in the US is of an unprecedented size, and may drive inflation higher

US fiscal deficit, M2 and Fed balance sheet



Increase in US budget deficit during recessions



The fiscal stimulus deployed by the US administration to fight the Covid-19 crisis is of an unprecedented magnitude. Including the recent $1.9tn package, it will lead to a higher US budget deficit than the combined stimuli deployed over the previous six recessions. In addition, the recently proposed $4.5tn plan by Biden may further fuel inflation.

Source: Amundi, Bloomberg. Data as of 31 March 2021.

Source: Amundi, Bloomberg Opinion. Data as of 8 March 2021. The estimated budget deficit increase in 2020-21 includes the recently approved $1.9tn fiscal package.

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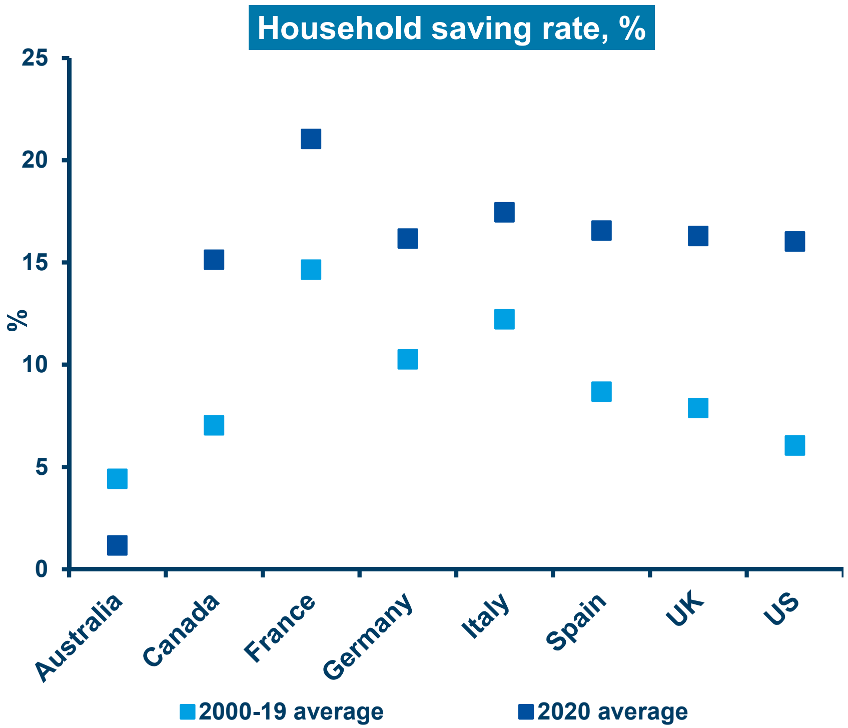
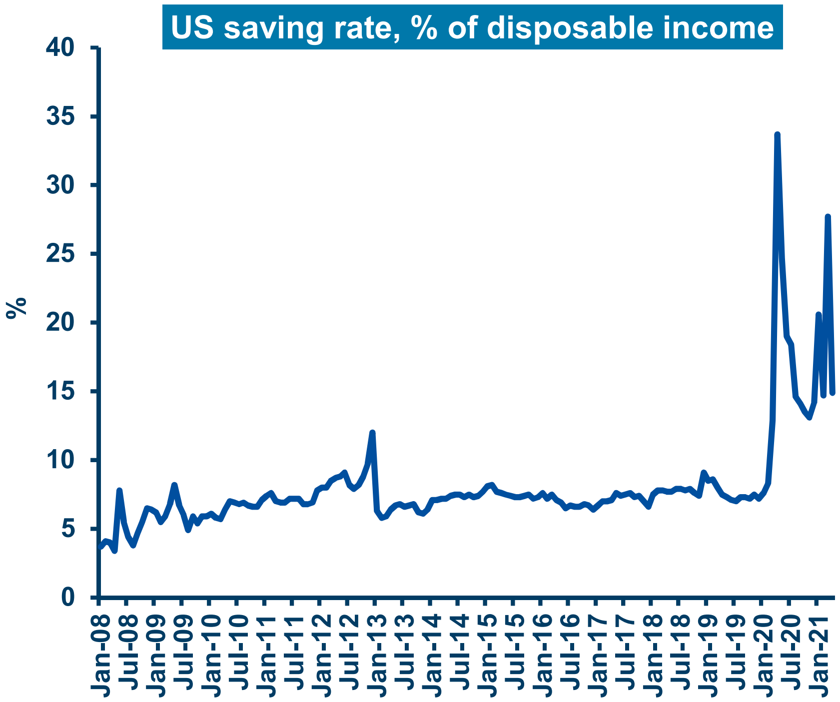
Excess savings could partly result in higher demand once the pandemic is over





Households across DM have accumulated an unusual amount of savings in 2020, as fewer spending options were available due to containment measures. These savings could fuel some strong pent-up demand once restrictions are lifted, adding to inflation pressures. In addition, this could support asset price valuations.

Source: Amundi on Bloomberg data as of 25 May 2021.

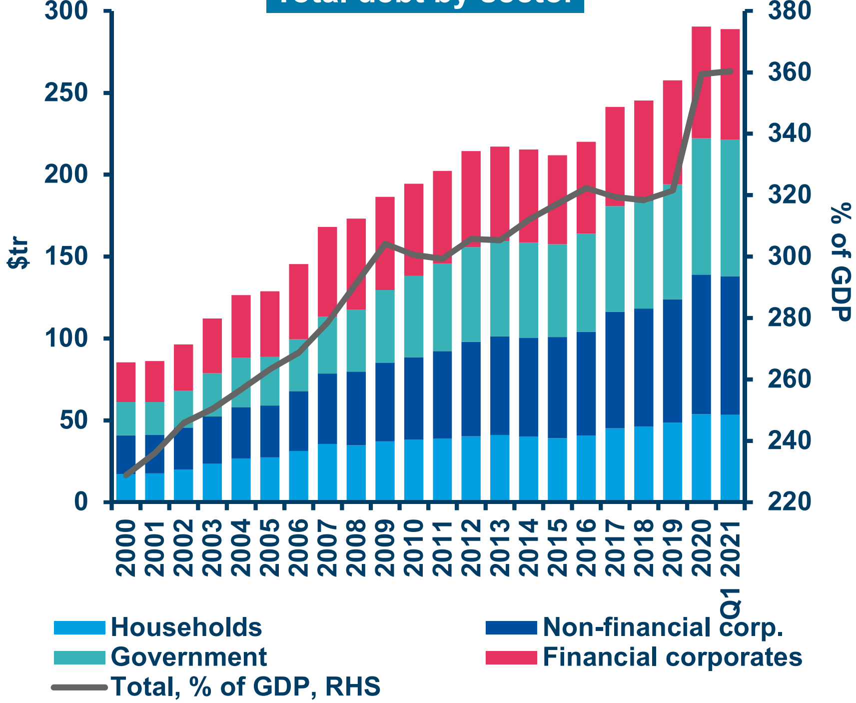
Source: Amundi on Bloomberg data. Latest monthly data as of 3 June 2021.

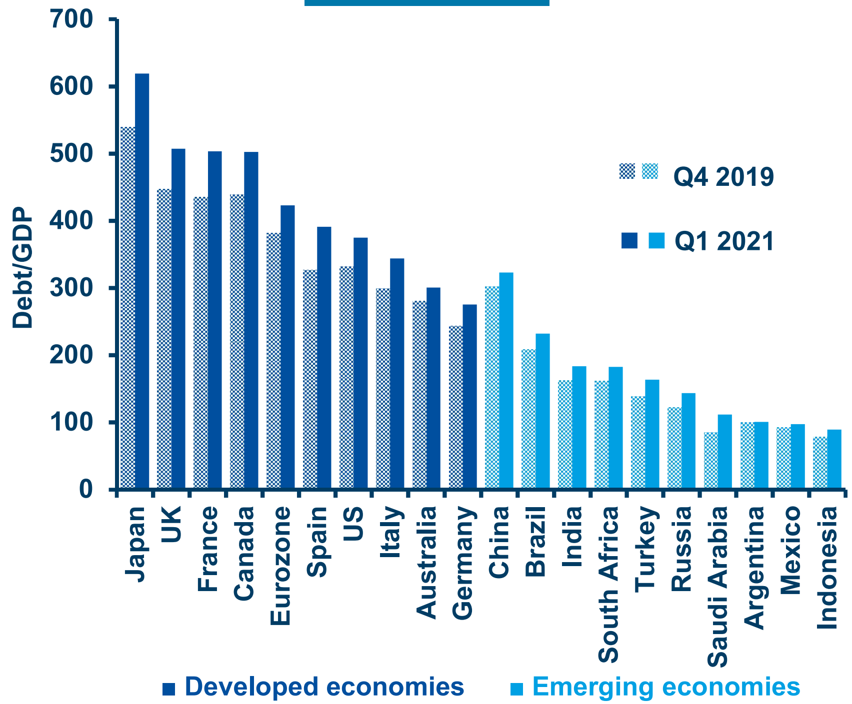
A regime shift is undergoing

- Central banks ready to keep accommodative monetary policies to help manage the debt burden
- Policy mix moving in the direction of rebalancing the power between labour and capital and to fight inequality
- Inflation pushed by supply chain disruption and higher food prices

"Today, the coexistence of the monetary narrative coupled with the consequences of Covid-19 is creating a fertile ground for a shift towards a higher inflationary regime, a sort of back to the '70s scenario."

Higher inflation will improve the affordability of the record-high debt stock





» Total debt-to-GDP ratio spiked in 2020, hitting 360% of GDP at a global level. It stabilised in Q1 2021. Such an increase occurred across different sectors, with governments and corporates contributing the most, and hinges on the costs of the pandemic and the recession. In Q1 2021 this ratio has proved higher than it was before the Covid-19 crisis across both DM and EM.

Source: Amundi elaboration on IIF data as of 26 May 2021. Note: Total debt is the sum of government debt, household debt, financial sector debt and non-financial corporate debt.

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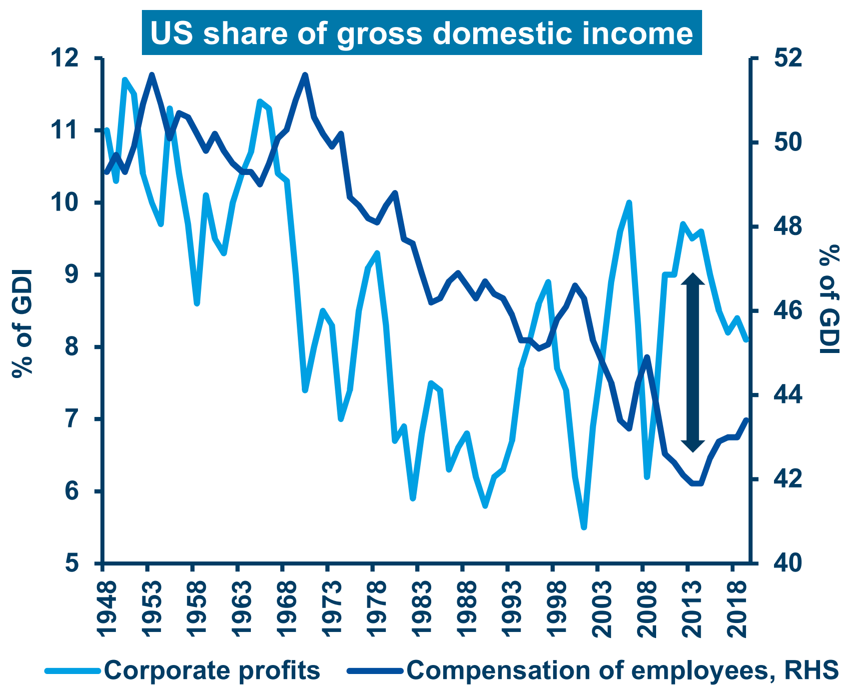
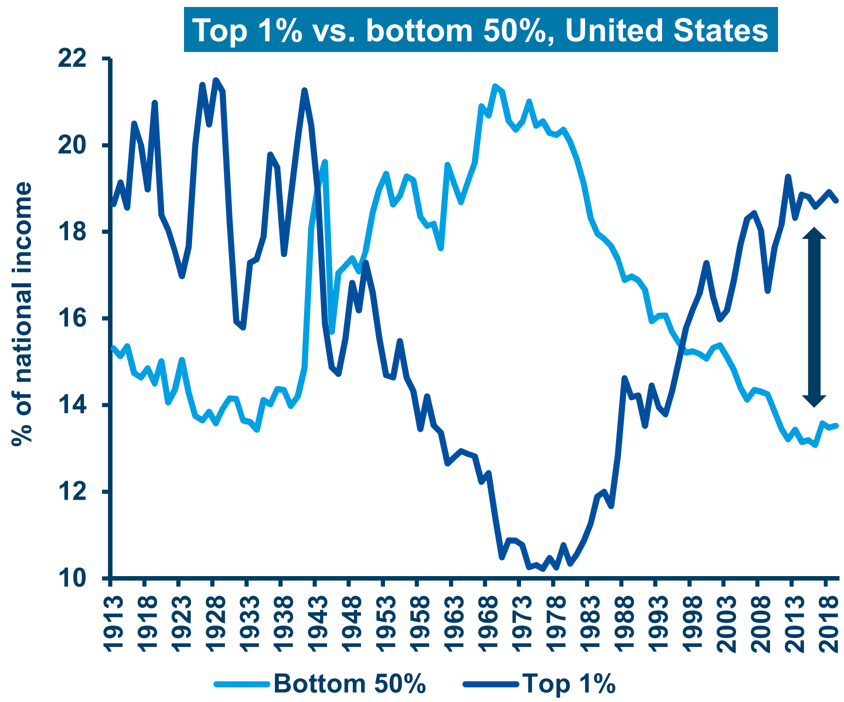
A rebalancing is needed between labour and capital to fight inequality





» The Biden administration could pursue policies aimed at accelerating a rebalancing of income share in favour of labour and the fight against inequality. This will be an additional force pushing towards a regime shift.

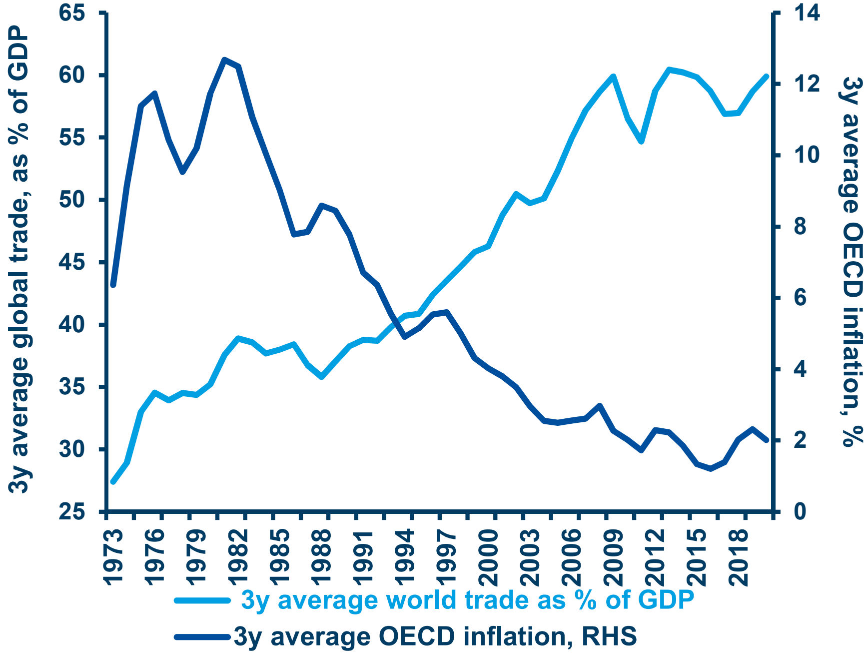
Source: Amundi on Bloomberg data as of 12 February 2021.

Source: Amundi, World inequality database. Data as of 12 February 2021.

De-globalisation and supply chain disruption could fuel inflation

Food supply chain challenged by global lockdown along all its parts

Global trade and OECD inflation trends



Food prices are rising quickly. The disruption of supply chains is leading to a regionalisation of trade dynamics compared to global ones. The environment is more friendly for regional relationship than for broader globalisation, pushing up prices.

Source: FAO as of 21 April 2021.

Source: Amundi, Bloomberg, OECD. Data as of 26 May 2021.

02

Investment: how to deal with higher inflation

Investment ideas to inflation-proof portfolios

Bonds

- Short and active on duration
- Inflation-linked bonds
- Floating-rate notes
- Securitised assets, sectors linked with cyclical recovery
- Beyond benchmark approaches

Equities

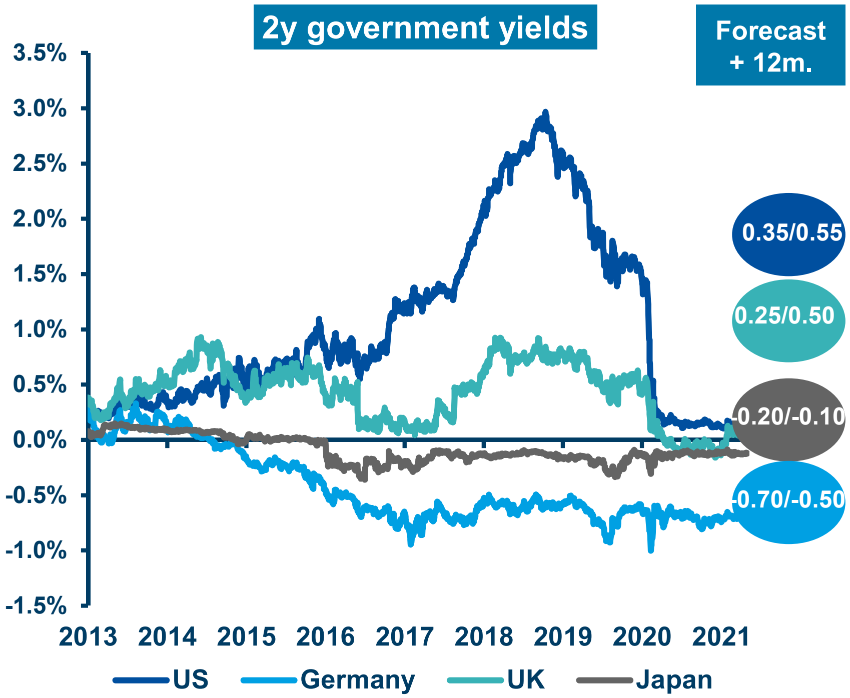
- Multi-year rotation towards value, cyclical stocks
- Cautious on highly interest-rate-sensitive stocks (hyper-high growth)
- High dividend stocks

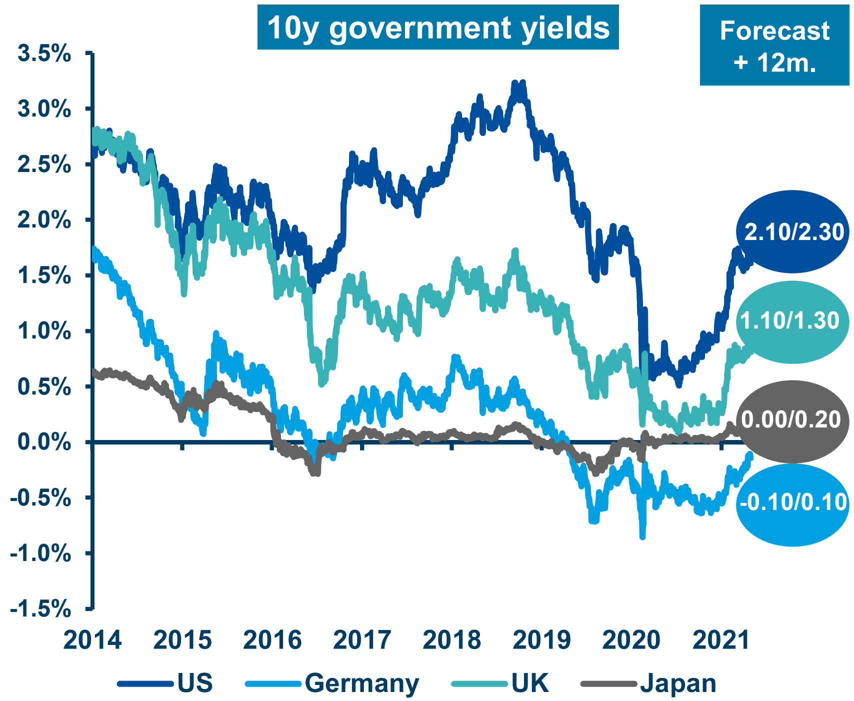
Cross-assets

- Equities over bonds, aware of changing correlation dynamics
- Exposure to real/alternative assets
- Strategies to target real returns

Source: Amundi, as of 31 May 2021.

Bonds: cautious, flexible on duration; resist the temptation to go long too soon





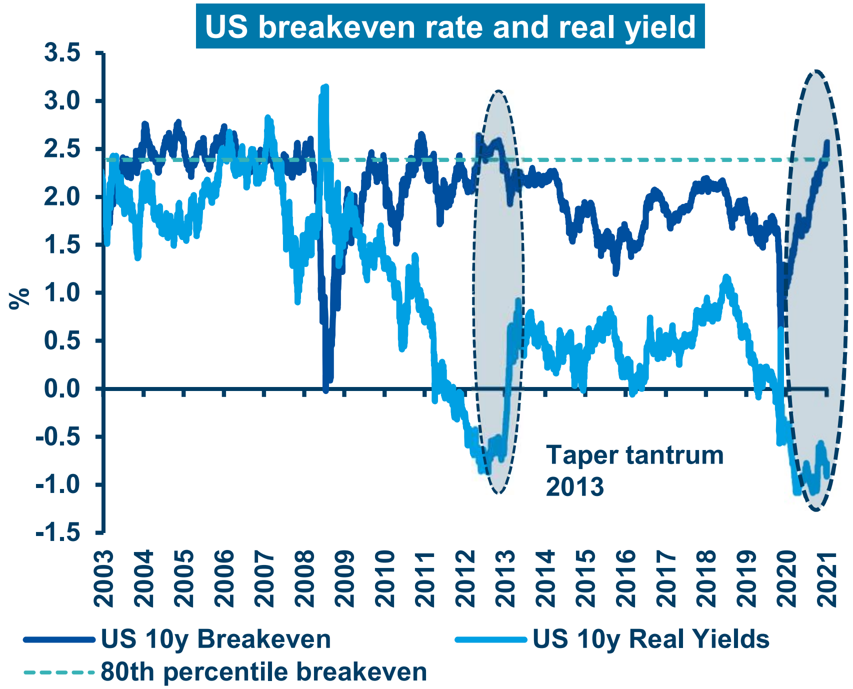
While US and EU inflation expectations have been rising this year, nominal yields have remained in a range. As a result, real rates are stuck in negative territory. This means that investors should watch the movement of nominal and real yields and stay active on duration. In doing this, investors should not make the mistake of going long duration because the general direction of rates is upwards; it will not be a straight line, but increased Treasury issuance and economic growth mean duration would be under pressure.

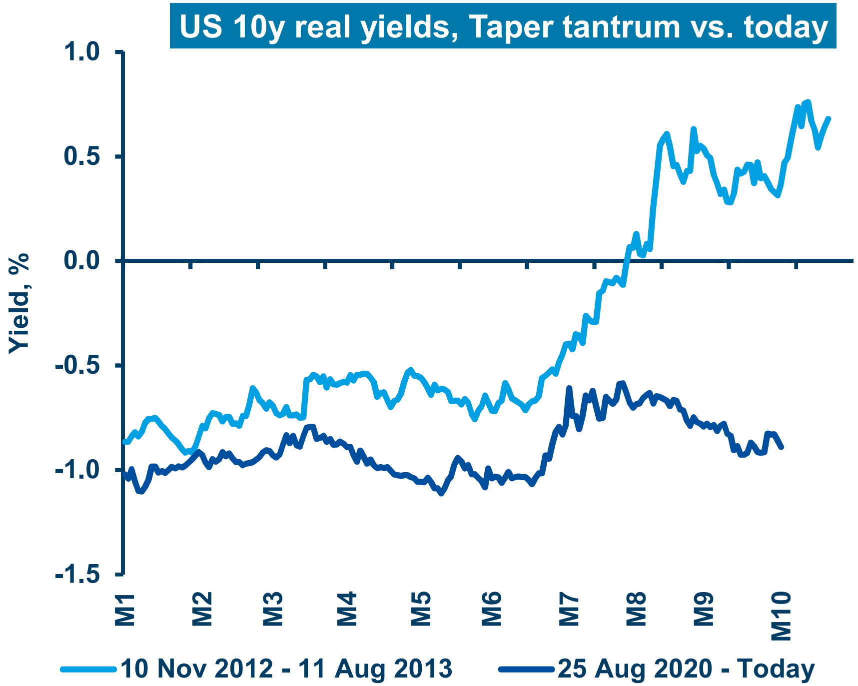
Source: Amundi, Bloomberg, as of 27 May 2021.

Source: Amundi, Bloomberg as of 24 May2021.

Bonds

Watch the sequence of real yields





» US inflation expectations have been rising over the past year reaching into overbought territory (80th percentile above), but real long-term yields started rising only recently – and are still negative – as markets started to price in some potential tapering by the Fed or rate hikes in the next few years. We see two sequences for real rates: the first sequence will see them move down, dragged down by higher inflation, in the second sequence they will move higher, along with nominal rate normalisation. This will be far less benign.

Source: Amundi, Bloomberg. Data as of 24 May 2021.

Source: Amundi, Bloomberg. Data as of 24 May 2021. M1, M2, etc refer to the first, second etc. month of each phase.

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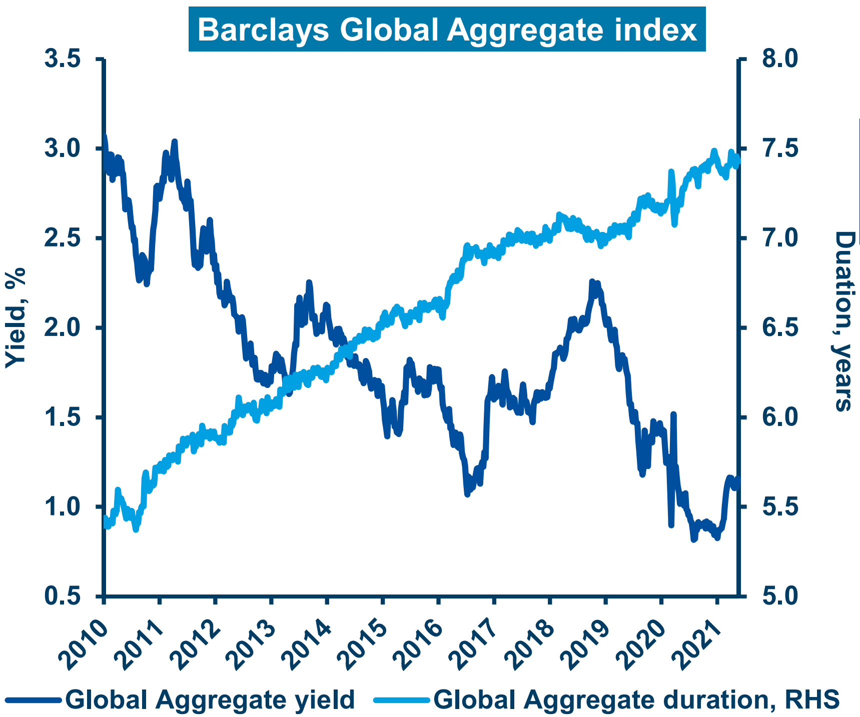
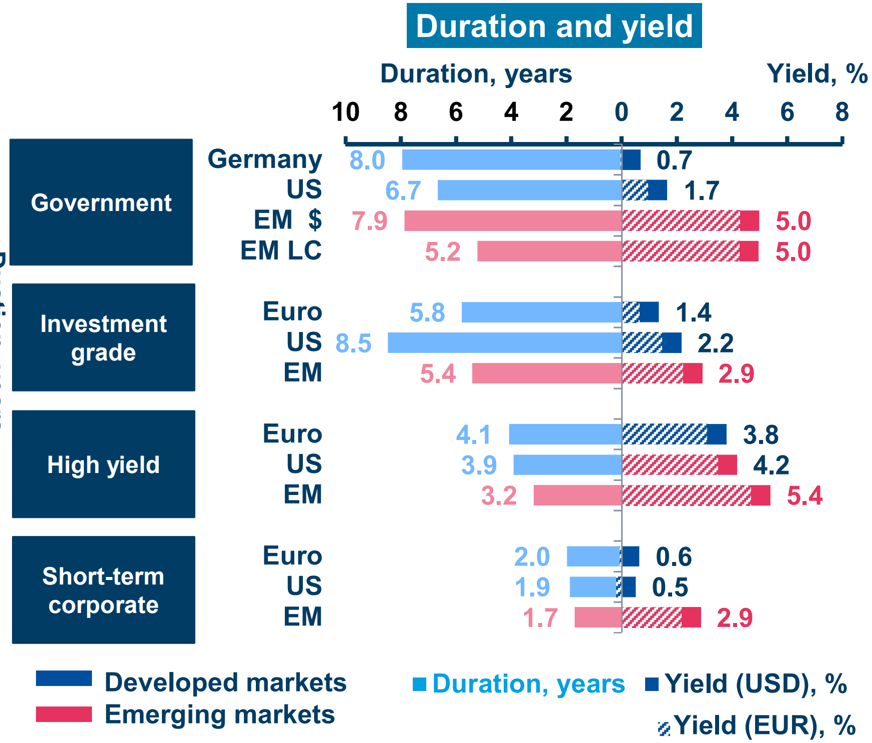
Bonds

Remain agile and diversify, with a focus on short duration assets



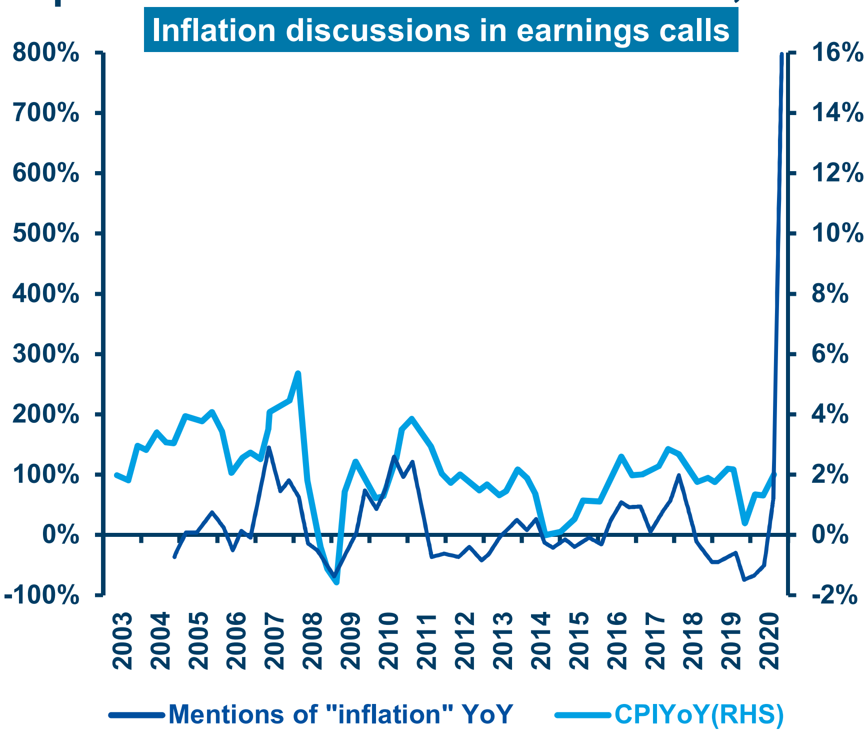


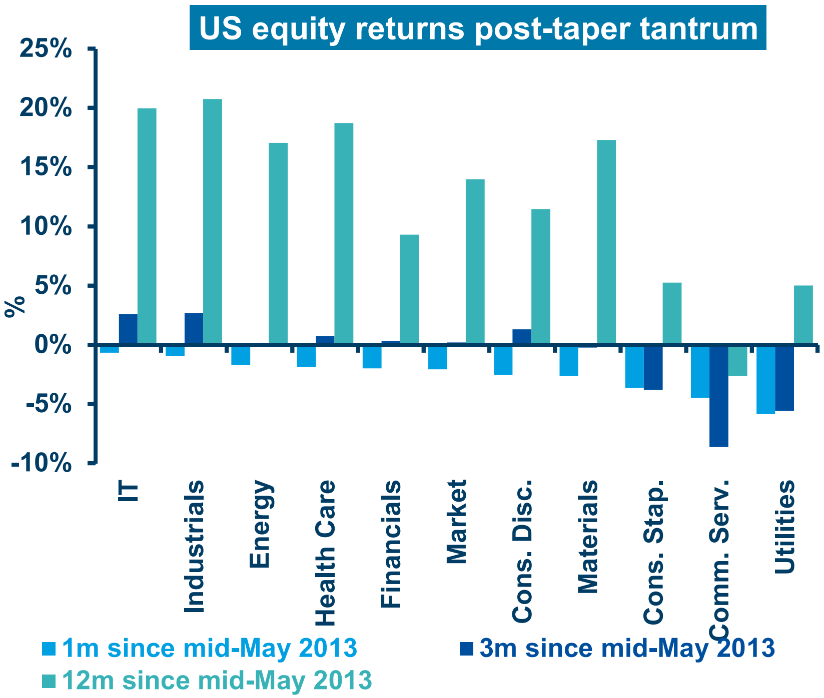
» Global fixed income indices have high duration and low yield: a small increase in yield translates into capital losses. Investors should go beyond benchmark allocations with flexible solutions that can mitigate duration risk. The current environment of possible higher inflation bodes well for short duration assets.

Source: Amundi analysis on Bloomberg data as of 24 May 2021.

Source: Amundi analysis on Bloomberg data as of 23 May 2021. Euro short term as on 21 May 2021.

Inflation is hot in earnings calls, tapering talks could affect equities in the short term, with varied impact on sectors





» Rising inflation and a taper tantrum are some important market concerns. In 2013, there was a short-term correction in equities, but that was overcome in the following twelve months. However, this does not mean that investors should not be vigilant. In fact, investors should stay active, with the potential to explore better entry points in the future.

Source: BofA Global Research, Bloomberg, as of 3 May 2021. Year-on-year growth in ‘inflation’ mentioned (starts from 2004) in earnings calls of S&P 500 companies.

Source: Amundi Research, Bloomberg as of 30 April 2021.

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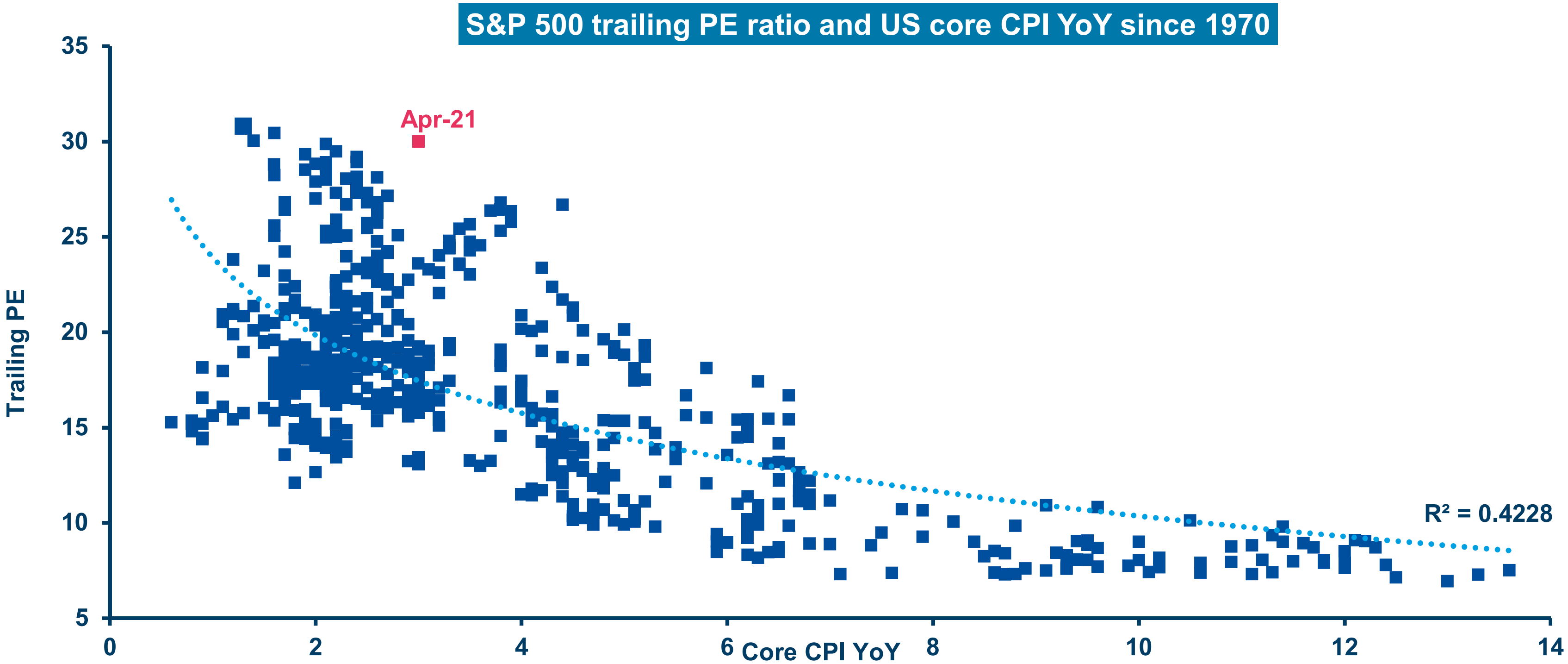
Equities: inflation may challenge high stock valuations

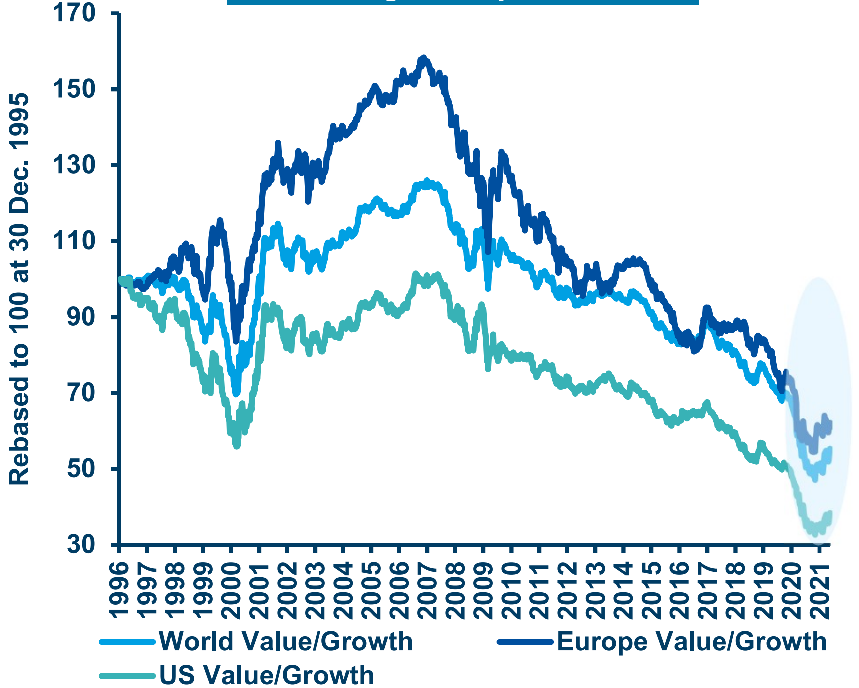


» Higher inflation affects stock valuations by putting upward pressure on prevailing interest rates, impacting the cost of capital used to discount future cash flows. However, companies that can grow earnings in an improving economy and pass rising input costs onto consumers, eventually become the winners. Investors should explore businesses that have strong pricing power, displayed in the form of strong brands, intellectual property, etc.

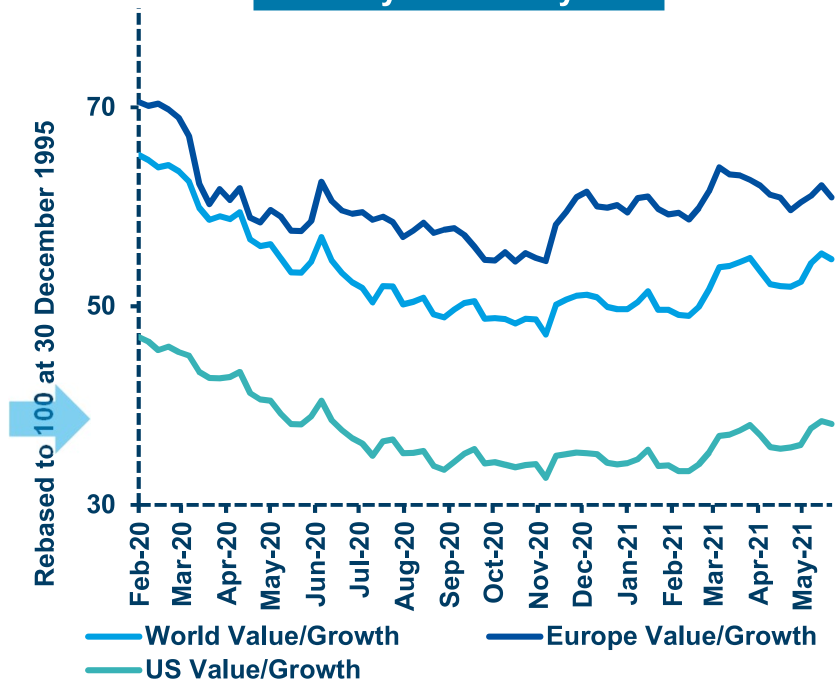
Source: Amundi, Bloomberg, as of 30 April 2021. Data starts from January 1970.

Inflation should support Value rotation, but it won't be a straight line

Value vs. growth performance



February 2020 – May 2021

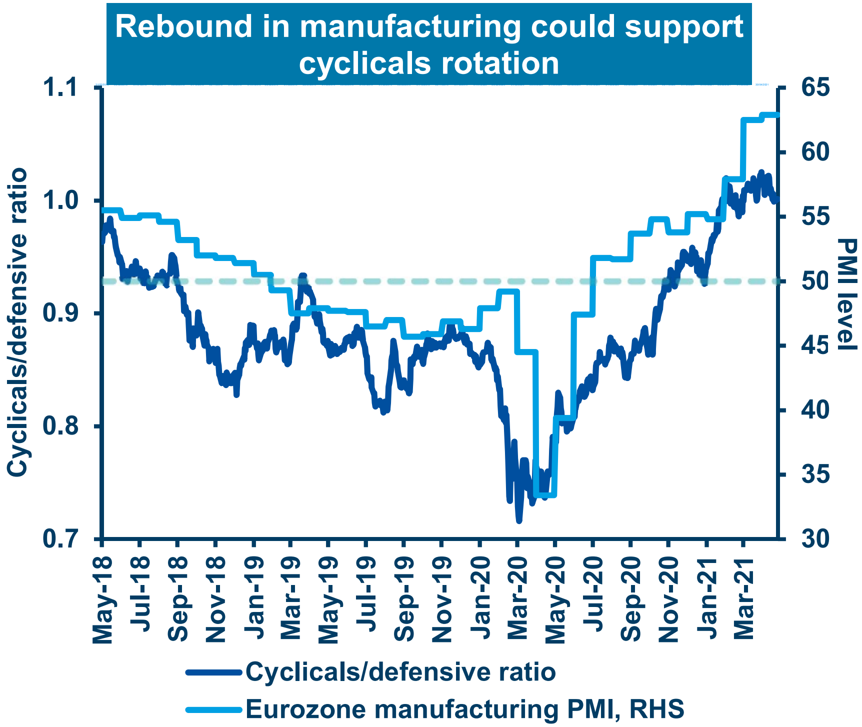


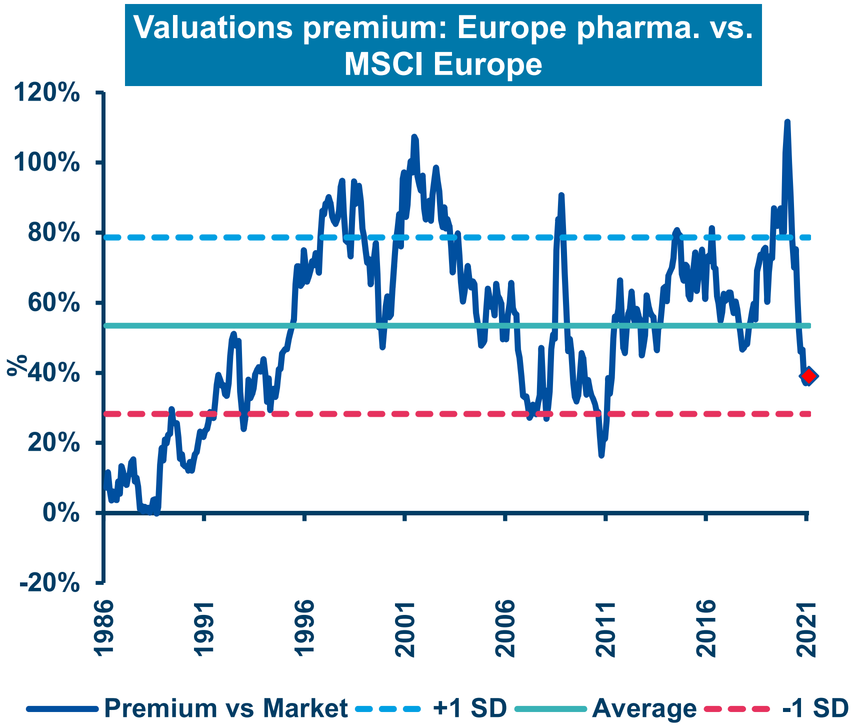
» We believe leadership rotation will be driven by an improving economy, even though we acknowledge a brief pause in economic momentum. Interestingly, we are in that phase of the value rotation where divergences across countries will be high and rotations will not be straightforward. Therefore, earnings growth and stock selection will be paramount.

Source: Amundi, Bloomberg, as of 21 May 2021.

Source: Amundi, Bloomberg, as of 21 May 2021.

EU: cyclicals likely to do well; balance with defensives





Reopening of economies and a pick-up in vaccinations should drive a rebound in manufacturing activity, which should boost areas linked with a cyclical recovery. On the other hand, there are selective attractive opportunities in the defensive segments. But investors should be mindful of a brief pause in momentum and extreme valuations in some segments of the market. Overall, a balanced stance is recommended.

Source: Amundi, Bloomberg, as of 25 May 2021.

Source: Amundi Research, DataStream as of 21 May 2021. % premium of MSCI Europe Pharmaceuticals calculated vs MSCI Europe on basis of Price to earnings ratio, Price to book value, Price to cash flow and dividend yield.

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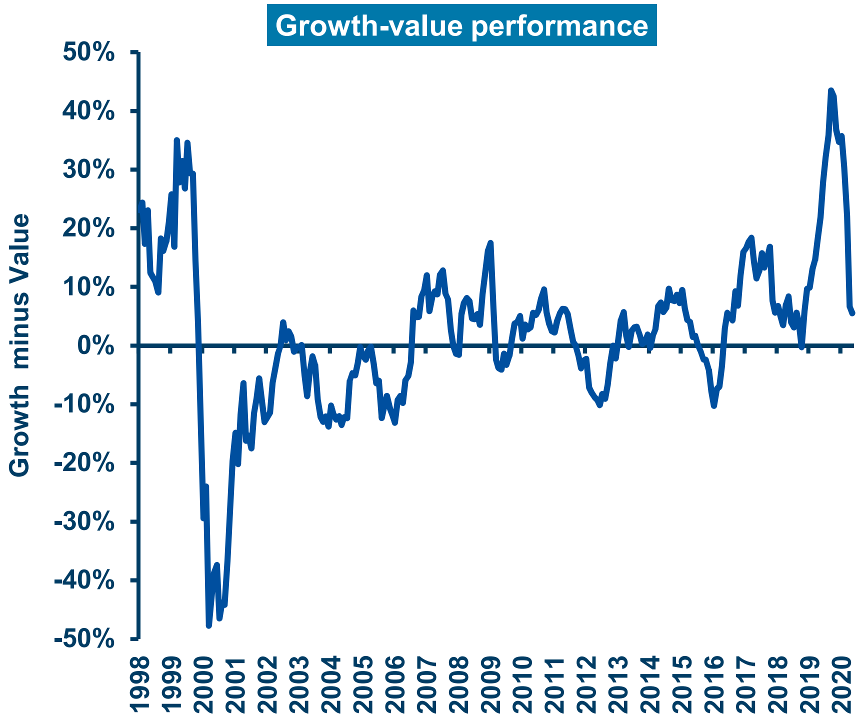
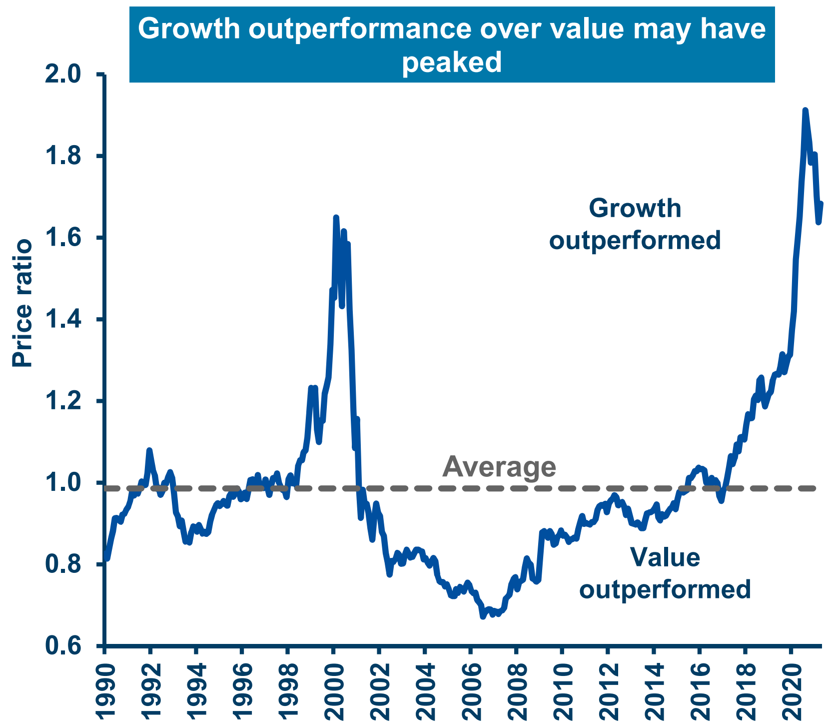
US: value in value investing



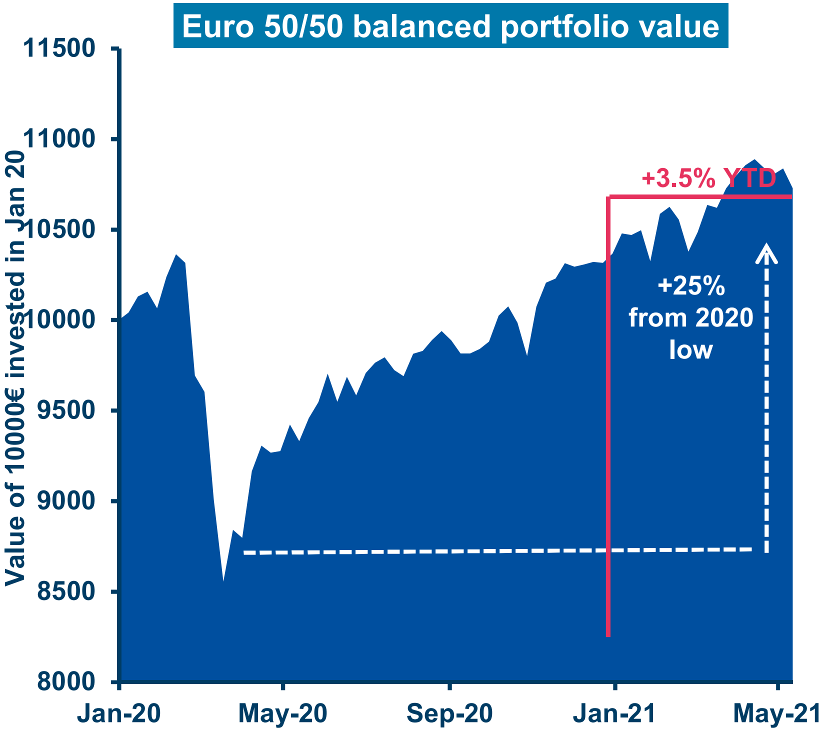


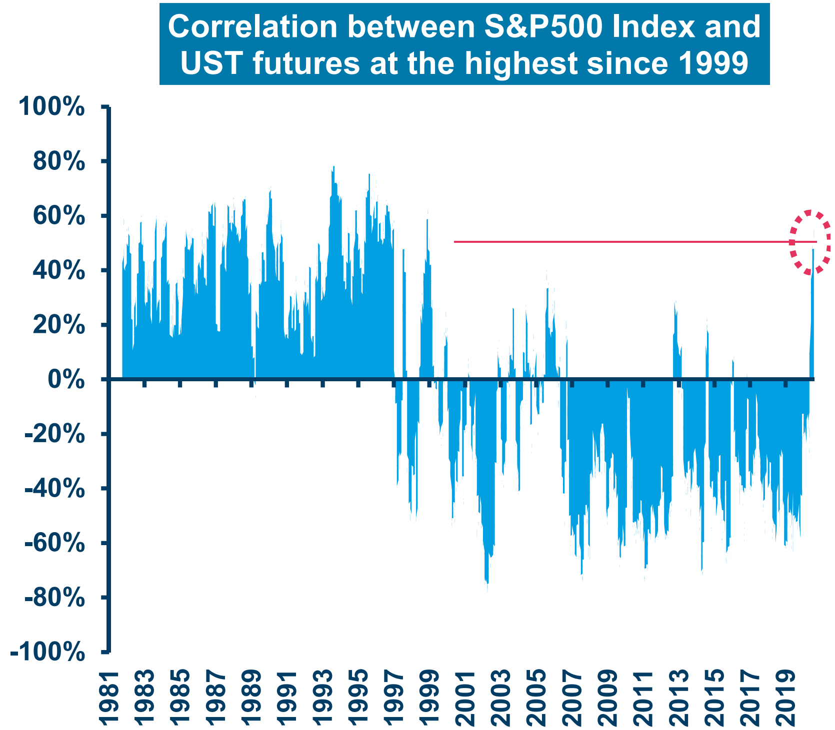
A combination of cyclical recovery and valuation differential between Growth and Value should sustain this rotation favouring the latter. In addition, value stocks, such as financials and energy, provide a sort of a hedge against inflation, which is rising as a result of the huge surge in demand and supply shortages/bottlenecks.

Source: Amundi, Bloomberg, as of 30 April 2021. **Past performance is no indication of future results**. Chart shows rolling 1y relative performance of the Russell 1000 Growth index compared to the Russell 1000 Value index in total return terms. The Russell 1000® Value index measures the performance of large cap US value stocks. The Russell 1000® Growth index measures the performance of large cap US growth stocks.

Source: Amundi on Bloomberg data as of 30 April 2021**. Past performance is no indication of future results.** The Russell 1000® Value index measures the performance of large-cap US value stocks. The Russell 1000® Growth index measures the performance of large-cap US growth stocks. Indices are unmanaged and their returns assume reinvestment of dividends and -- unlike mutual fund returns -- do not reflect any fees or expenses associated with a mutual fund. It is not possible to invest directly in an index.

Inflation affects bond-equity correlation, challenging traditional portfolio diversification





YTD performance of balanced portfolios has been positive and the overall loss registered during the pandemic correction has been more than recovered. The inflation moment brings challenges, as not only rising volatility but also changes to correlation dynamics.

Source: Amundi on Bloomberg. Simulated balanced portfolio with 50% MSCI World in euros and 50% Bloomberg Barclays Euro Aggregate Bond Index. Data as of 14 May 2021. **Past performance is no guarantee of future results**..

Source: Amundi, Bloomberg, as of 19 May 2021. 60-day correlation rolling.

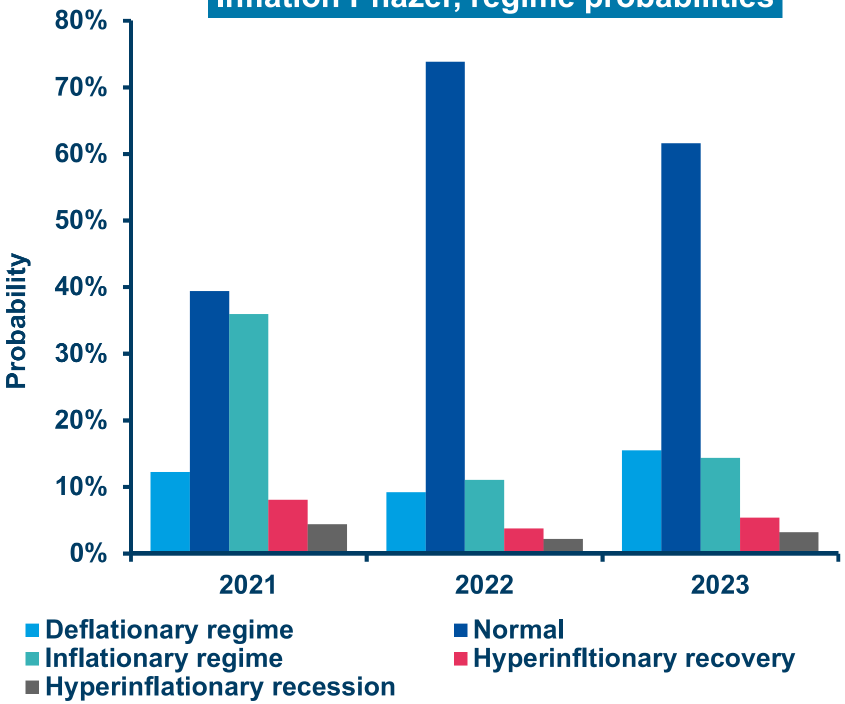
Inflation rates will likely normalise, risk of overshoot in 2021

Inflation regime features

	Deflation regime	Normal	Inflation regime	Hyper-inflation recovery	Hyper-inflation recession
CPI YoY, %	<2	2-3	3-6	6-10	>10
PPI YoY, %	<1	2-3	3-6	6-10	>10
PCE YoY, %	<2	2-3	3-6	6-8	>8
ULC YoY, %	<1	2-3	3-6	6-9	>9

Source: Amundi Research. Data are from 31 January 1959 to 31 December 2020. CPI: Consumer price index. PPI: Producer price index. PCE: Personal consumption expenditure deflator. ULC: Unit labour costs.

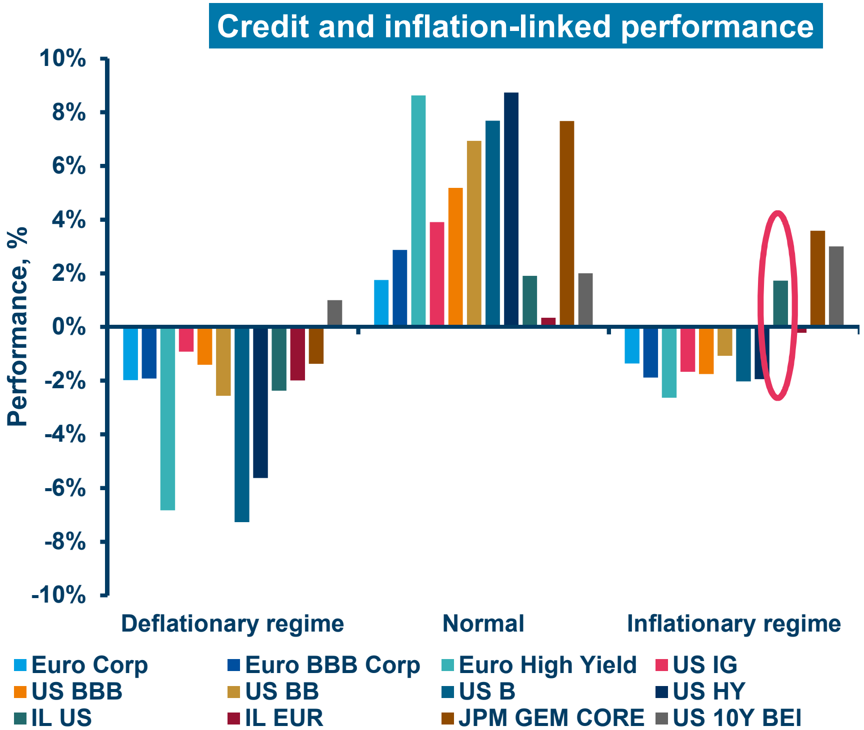
Inflation Phazer, regime probabilities

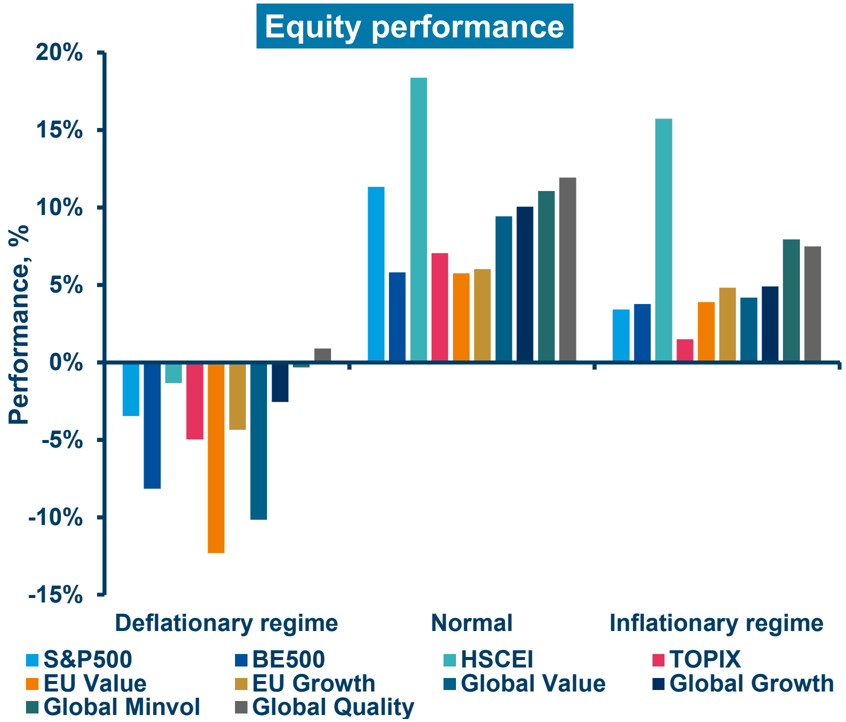


Source: Amundi Research as of 19 May 2021.

» Our Inflation Phazer tool identifies five different inflationary regimes to assess which asset class should perform better in each environment. These regimes are identified by analysing historical trends of the most relevant US inflation indicators. According to our model, this year we have a relatively high probability of seeing an inflationary regime and more normal rates in 2022-23.

Inflation-linked bonds tend to perform well in higher inflation regimes





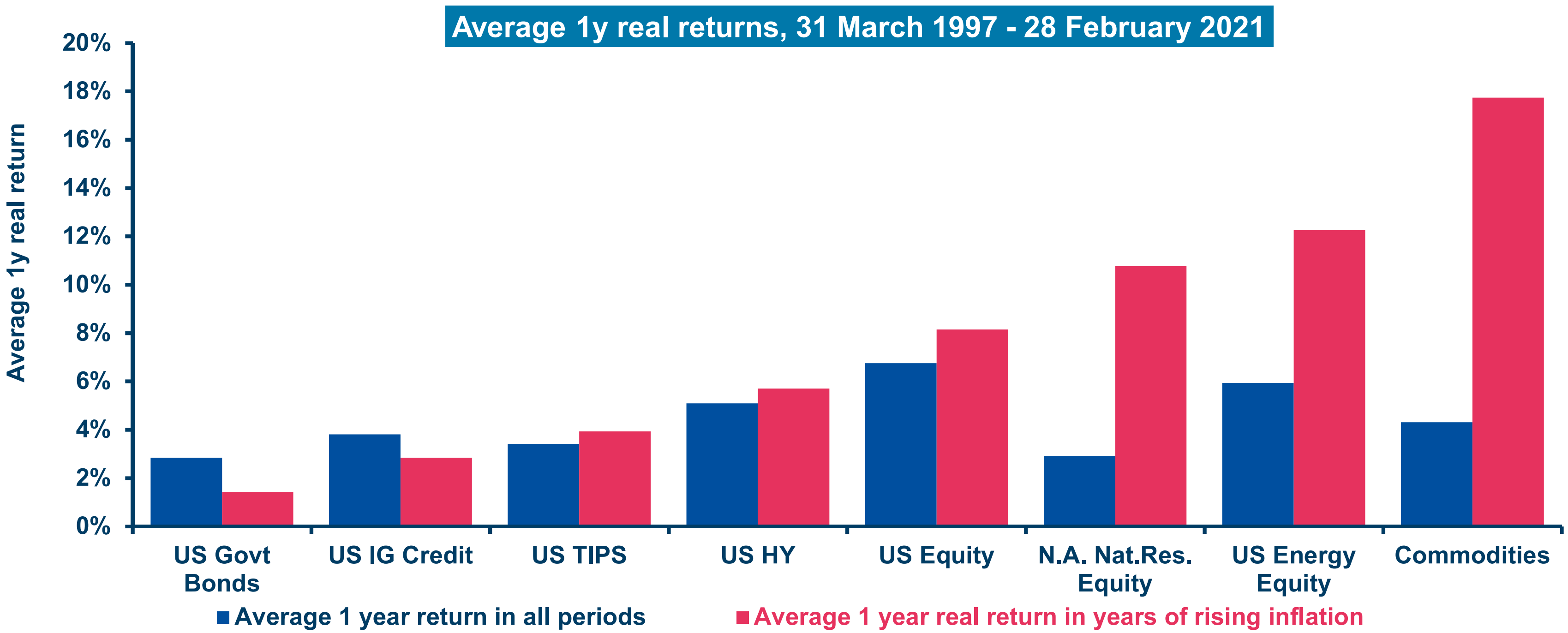
Credit indices tend to perform at their best during normal inflation periods, while they underperform in inflationary times, when monetary policy is tight and credit spreads widen. Inflation-linked bonds' relative performance against credit is the most attractive under an inflationary regime. Normal inflation has proved the best environment for equity as well.

Source: Amundi Research. Data as of 7 April 2021. Credit performance is in total return terms. Data are from 31 January 1959 to 31 December 2020.

Source: Amundi Research. Data as of 7 April 2021. Equity performance is in total return terms. Data are from 31 January 1959 to 31 December 2020.

Amundi ASSET MANAGEMENT

…as well as commodities and equity sectors linked to the real economy



» In a rising inflation environment, government bonds and IG credit tend to underperform, while TIPS and US HY outperform. Commodities and equity sectors linked to the real economy are the winners.

Source: Amundi calculations on Bloomberg. Analysis on monthly. Equity indexes refers to S&P 500 indexes and related sectoral sub indexes. Bond indexes are from Bloomberg Barclays, Commodity index is the S&P GSCI Commodity Index. All data are in USD total return. Return in years of rising inflation refers to years when the end value of CPI was greater than the CPI value at the beginning of the year. Data from 31 March 1997 to 28 February 2021.

“We are at the start of a journey towards a mid- to long-term period of higher inflation and lower growth compared to the current consensus. Investors should prepare portfolios for a structurally higher inflation or the ‘road back to the 70s,’ as we say.”

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Indices reference & definition

Bond Indices (JPMorgan)

Sov. HC HY = JPM EMBI Global Diversified High Yield; Sov. HC = JPM EMBI Global Diversified Composite; Sov. HC IG = JPM EMBI Global Diversified Inv. Grade; Local FX = JPM GBI-EM Global Diversified FX Return; Local HC = JPM GBI-EM Global Diversified Composite Unhedged USD; Local Euro = JPM GBI-EM Global Diversified FX Return in EUR; Local Rates = JPM GBI-EM Global Diversified Composite LOC; Corp. HC HY = JPM Corporate Broad EMBI Diversified High Yield; Corp. HC = JPM Corporate EMBI Broad Diversified Composite; Corp. HC IG = JPM Corporate Broad EMBI Diversified High Grade.

Equity Indices (MSCI)

Argentina = MSCI Argentina Net Total Return; Brazil = MSCI Brazil Net Total Return; China = MSCI China Net Total Return; Czech Republic = MSCI Czech Republic Net Total Return; Colombia = MSCI Colombia Net Total Return; Egypt = MSCI Egypt Net Total Return; India = MSCI India Net Total Return; Indonesia = MSCI Indonesia Net Total Return; Mexico = MSCI Mexico Net Total Return; Peru = MSCI Peru Net Total Return; Philippines = MSCI Philippines Net Total Return; Poland = MSCI Poland Net Total Return; Russia = MSCI Russia Net Total Return; South Africa = MSCI South Africa Net Total Return; South Korea = MSCI Korea Net Total Return; Taiwan = MSCI Taiwan Net Total Return; Thailand = MSCI Thailand Net Total Return; Turkey = MSCI Turkey Net Total Return; Emerging Markets = MSCI Emerging Net Total Return.

Yield & Duration Indices

German Govt Bonds = JP Morgan GBI Germany Index; US Govt Bonds = JPMorgan GBI US Index; Euro IG Bonds = Bloomberg Barclays Pan European Aggregate Corporate; US IG Bonds = Bloomberg Barclays US Aggregate Credit; Euro HY bonds = Bloomberg Barclays Pan-European High Yield ISMA; US HY Bonds = Bloomberg Barclays US Corporate High Yield; EMBI Div = JPMorgan EMBI Global Diversified Blended; CEMBI BD = JPMorgan CEMBI Div Broad Composite Blended; CEMBI BD HY = JPMorgan CEMBI Broad Div High Yield; Euro Corp Short Term = Bloomberg Barclays Euro Corporate 1-3Yr; US Corp Short Term = Bloomberg Barclays US Corporate 1-3Yr; EMBI Short Term = JPMorgan EMBIG Diversified 1-3Yr.

Definitions

- Basis points: one basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- Correlation: the degree of association between two variables; in finance, it is the degree to which assets or asset class prices have moved in relation to each other. Correlation is expressed by a correlation coefficient that ranges from -1 (perfectly negative correlated) through 0 (absolutely independent) to 1 (perfectly positive correlated).
- Credit spread: differential between the yield on a credit bond and the Treasury yield. The option-adjusted spread is a measure of the spread adjusted to take into consideration possible embedded options.
- Duration: a measure of the sensitivity of the price (the value of principal) of a fixed income investment to a change in interest rates, expressed as a number of years.
- Spread: the difference between two prices or interest rates.
- Volatility is a statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.

Important information

Date of first use: 7 June 2021.