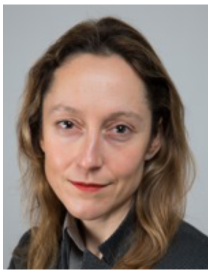
THEMATIC

Fed officials' discomfort is growing with the inflation overshoot: why it will remain cautious



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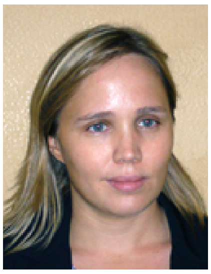

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US consumer prices jumped by 6.2% in October, their highest level in 30 years! Deteriorating inflation data have pushed markets towards forecasting a faster pace of tapering and a more rapid removal of accommodation in 2022. We expect the Fed to act gradually as Covid remains a major risk and as the Fed would like to see a higher participation rate. The Fed will have a step-by-step approach and a rapid turnaround in strategy is possible. To a greater extent, a high level of debt, a tight valuation of assets, and the huge investments required to move to a low-carbon economy will limit the Fed's ability to raise rates.

The current high level of inflation is due to very strong demand meeting bottlenecks and shortages. The Covid-19 crisis has been characterised on the one hand by impressive lockdowns and supply-chain disruptions and on the other hand by unprecedented support from governments and central banks. These support measures have aimed to preserve demand and limit long-term damage to our economies. For central bankers and fixed-income investors, the challenge in 2022 will be to predict: (1) the persistence of supply constraints and lockdowns, (2) the sustainability of demand, and (3) their joint effects on inflation and growth. Indeed, it is crucial to determine what conditions will be like on the labour market and what the drivers of inflation will be: costs and/or strong demand. These points will be decisive in the Fed's reaction to this more inflationary environment. Rising rates cannot resolve supply-side shocks. In addition, for the Fed, it is appropriate to be "patient" to determine the true state of the economy and to assess potential structural changes.

"The inflation that we're seeing is really not due to a tight labour market, it's due to bottlenecks and it's due to shortages and it's due to very strong demand meeting those"
(Jerome Powell)

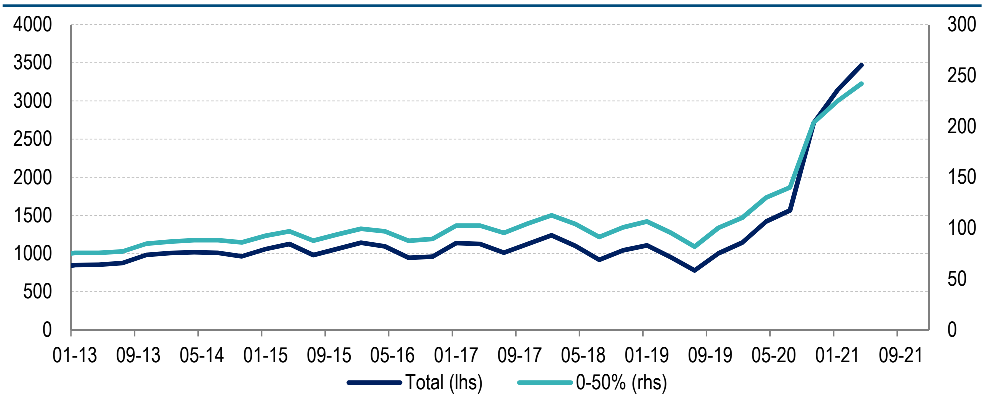
US inflation pressure should ease in early 2022, if the pandemic remains under control

We expect inflationary pressures to remain above 5% through the end of the year and into the first quarter of 2022 and begin to ease in the second quarter as supply-chain bottlenecks ease and demand normalises. Nevertheless, core PCE inflation should stay above the FOMC's 2% target all next year. We forecast 2.4% YoY core PCE at the end of 2022, with risks still tilting towards the upside.

— **Barring a worldwide resurgence of Covid cases, supply bottlenecks should ease in early 2022 as:**
  - Asian mobility has improved constantly as the pace of vaccination accelerates.
  - President Biden has made resilient supply chains a top priority. One flagship measure: the Port of Los Angeles is now operating 24 hours a day.
  - There is a seasonal drop in US port activity in February and March. August through early November is usually the peak season as retailers prepare for the holidays. This seasonal decline in the level of activity can help normalise inventories.
  - Shipping prices have begun to fall. The Baltic Exchange's Dry Bulk sea freight index reached a low since early June thanks to the weaker demand for the larger Capesize and Panamax vessels.

— **Demand for goods is expected to normalise in early 2022 as official Covid-19 support measures fade:**
  - The strong support to consumption provided by the liquidity buffer accumulated during the pandemic should fade. US households' "excess savings" dropped by the end of September

1/ Checkable deposits and currency holdings by income group (in $Bn)



Source: Bloomberg, Amundi Research - Data as of 1st April 2021

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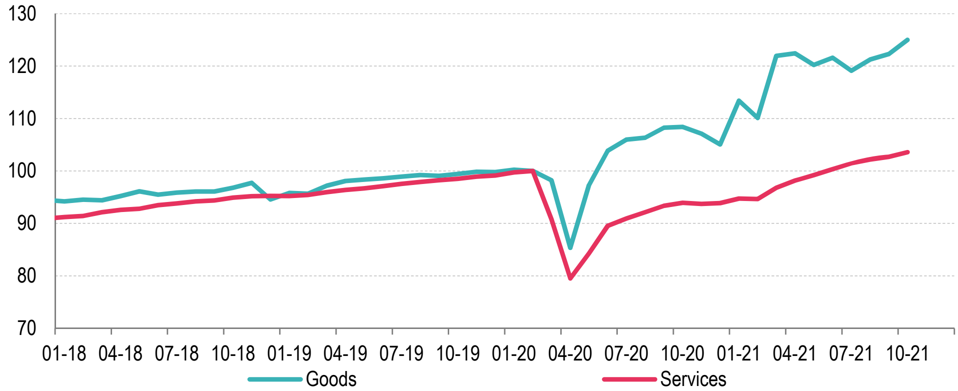
"It is very difficult to predict the persistence of supply constraints or their effects on inflation. Global supply chains are complex" (Jerome Powell)

"Our tools cannot ease supply constraints" (Jerome Powell)

to $1.3 trillion or 7.3% of disposable income on annual basis, only slightly above their pre-pandemic level. Overall, we could assume that $2.4tr in excess savings have been accumulated during the pandemic. However, we estimate that only 20% or 0.5tr is held by the bottom two quintile combined.

- Overconsumption of goods compared to services should decline with the reopening of economies. US consumers have gone on a "spending binge," fuelled partially by stimulus checks and have been buying goods rather than spending money on services. Indeed in 2021, US residents will have spent 20% more on durable and non-durable goods than in 2019.

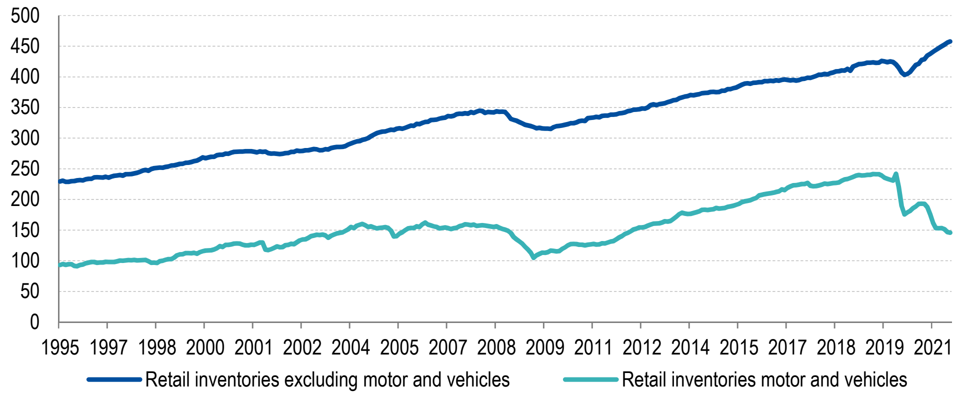
2/ US consumer spending (100=dec 2019)



Source: Bloomberg, Amundi Research - Data as of 31 October 2021

- Inventory should soon reach appropriate levels. Business inventories (excluding motor and vehicles) increased solidly in recent months (+0.7% MoM on average in 2021 vs. +0.2% on average in 2017-2019). US inventories have already risen above pre-Covid levels as retailers expect a strong holiday season. However, motor vehicle retailers continued to struggle to restock amid an ongoing global semiconductor shortage, which has undercut production.

3/ Retail inventories (in $Bn)



Source: Bloomberg, Amundi Research - Data as of 31 October 2021

- At the global level, the slowdown of the Chinese economy is playing a key role and should be monitored. A shortfall in global demand would ease inflationary pressures.

— **Wages keep accelerating depends largely on the duration of the labour shortages.** The US labour market is now running hot: job openings are at a historic high, the quit rate is at an all-time-high. Wages are rising sharply but low-wage sectors. The recent build-up in savings has given Americans some time to wait and some power to negotiate better employment terms. However, in the coming months, this liquidity buffer will wane especially for low-household income. These trends should normalise with the shrinking in savings.

We expect prices to remain higher than what prevailed between 2014 and 2020

— **Business costs are on the rise.**

- Commodity and energy prices should remain high.
- The longer the supply-chain crisis continues, the more inclined companies will be to secure their production chains and move away from highly globalised and 'just in time' supply chains. In particular, companies may start to over-order and carry heavier inventories as they shift from a just-in-time to a just-in-case model.
- The transition to a low-carbon economy also means higher costs and investment for companies.

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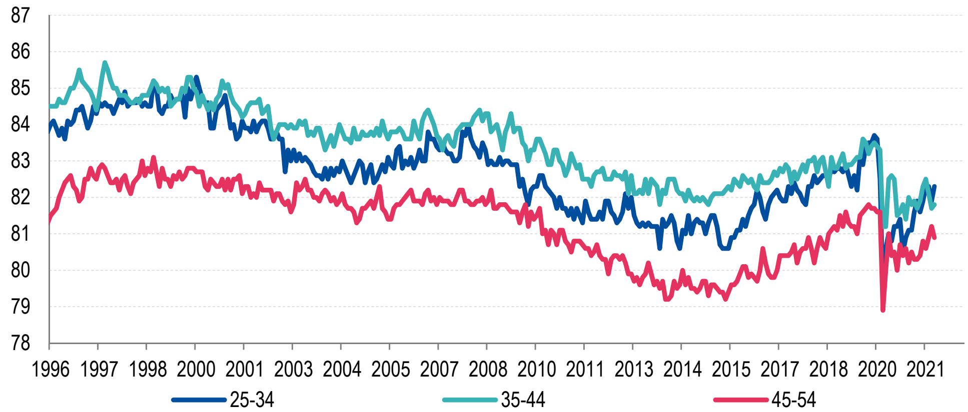
The Fed expects inflation to recede by Q2 or Q3 of next year

According to the Fed, "maximum employment" could be achieved by H2 of 2022. The Fed is calling for patience for a better assessment of the post-Covid macro picture, including the participation rate

— **The strength of demand is more questionable.**
- More social policies could play a key role in raising low wages.
- We also remain attentive about a possible structural decline in the participation rate in developed economies and in China. In the US, we observed a record level of retirements since the start of the pandemic. A more favourable family social policy (like an extension of child tax credit payments) could contribute to a more persistent decline in the participation rate of married people living with spouses. A persistent decline in the participation rate could contribute to higher structural wage growth. In any case, increases in wages are a concern only if they are rising persistently and materially above inflation and productivity gains.

4/ **Labour force participation rate (in %)**



Source: Bloomberg, Amundi Research - Data as of 31 October 2021

The Fed should normalise its monetary policy but not as aggressively as the market is pricing in. However, a rapid turnaround in strategy is possible

The Fed will start tapering bond purchases in November, as expected by the markets, and is ready to adjust the pace of purchases if needed. The focus is now on taper "speed" and when the rate normalisation process starts. We expect the first rate hike in June 2022.

— **The Fed should normalise its monetary policy.**
- The recovery is already well underway. US GDP was 1.4% higher than its pre-pandemic level in Q3 2021.
- Above-target inflation should persist. We forecast 2.4% YoY core PCE at the end of 2022, with risks still tilting towards the upside.
- Real yields are too low and are increasing risks to financial stability, including a surge in asset valuations, a record level of M&A, record share buybacks, increased issuance for LBO purposes.

— **We expect the Fed to remain cautious as Covid remains a major risk and as long as inflation is not due to a tight labour market. The Fed will have step-by-step approach and a rapid turnaround in strategy is possible.**
- The Fed expects inflation to move down by Q2 or Q3 of next year. "The inflation that we're seeing is really not due to a tight labour market."
- Our tools cannot ease supply constraints.
- According to the Fed, "maximum employment" could be achieved by H2 of 2022.
- There is a debate around the participation rate. For the Fed it is appropriate to be "patient" to decide what the true state of the economy is.

— **A persistent cost-push inflation would put central banks in a difficult position. A premature tightening will do more harm than good and would represent an unwarranted headwind for the recovery.**
- Rising rates can't solve supply-side shocks. Real long-term interest rates will have to remain low so that the necessary investment could be made.
- The low-carbon transition will also bring a considerable need for investment. Real long-term interest rates will have to remain low, as these investments offer low profitability and some will only replace destroyed capital.
- The strategy of keeping real rates low implies an increased need for redistribution in favour of low-income households. Financial markets could start to integrate quickly climate transition risks.

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CROSS ASSET
INVESTMENT STRATEGY

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