April 2021

How hot is the inflation pot?

Strategies to protect portfolios from inflation risk

Investment Insights | Market Stories

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Inflation-proof portfolios for a regime shift

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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, thanks to the recently-passed $1.9tn fiscal package, which includes $1,400 direct payments to US citizens earning $75,000 a year or less, which will be disbursed quickly. The cheques could result in a big boost to consumer spending as early as April and could equate to the unfolding of huge pockets of pent-up demand in those sectors which have been hit the most by lockdowns. These trends – which are expected to unfold over the next twelve months – will join forces with more structural trends and a likely regime shift towards higher inflation as a way out of the crisis, as recently highlighted in the paper “Don’t give up on fundamental valuations”.

Higher inflation will have huge investment implications and any portfolio construction exercise should be approached with this regime shift in mind. To build an inflation-proof portfolio, investors should consider increasing their allocation to assets such as inflation-linked bonds, real assets -- mainly real estate and infrastructure -- and commodities. In bonds, rising bond yields will warrant a cautious and active approach on duration, while searching for income across the entire market spectrum with a global unconstrained approach. In equities, higher inflation may dent equity valuations, especially those at highly expensive levels, and favour the multi-year rotation from growth to value stocks both in the United States and Europe. Cautiousness will be needed when investing in rate-sensitive stocks. From a cross-asset will be attractive in this respect. perspective, higher inflation will challenge traditional portfolio diversification, as the equity-bond correlation turns positive. Solutions may target real returns with a broad range of asset classes.”

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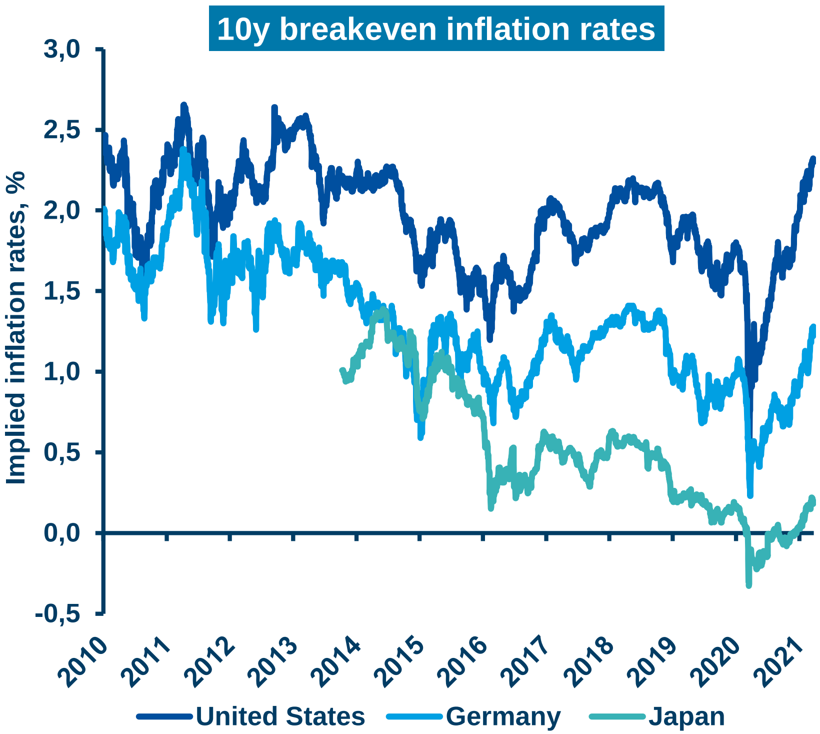
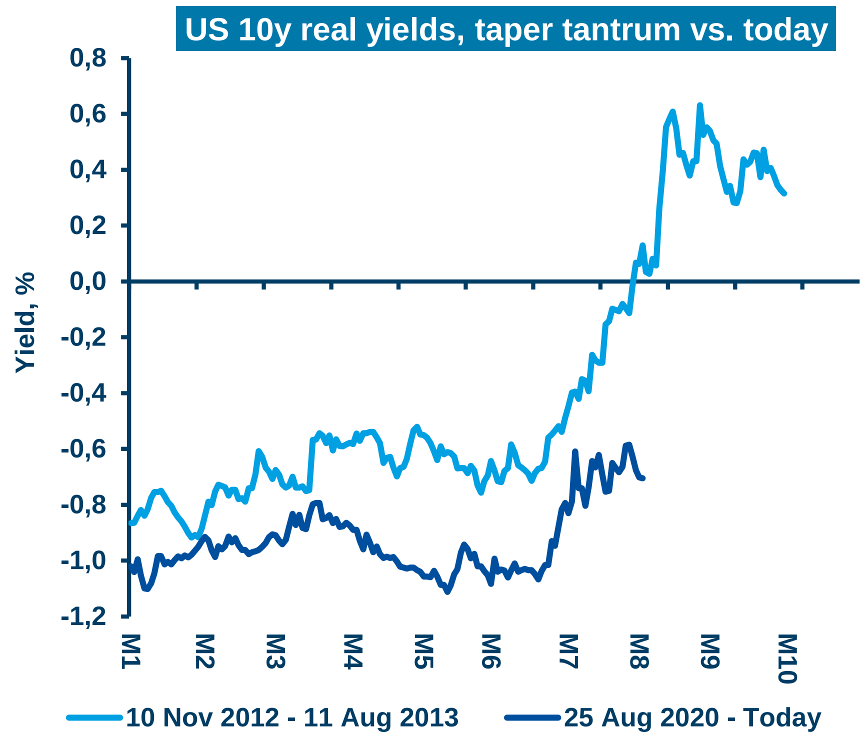
Reflation story is gaining traction, but not to tantrum territory



Source: Amundi, Bloomberg. Data as of 25 March 2021.



Source: Amundi, Bloomberg. Data as of 25 March 2021. M1, M2, etc refer to the first, second etc.. month of each period.

After bottoming in March 2020, inflation expectations have rebounded markedly. In the United States, they have soared following the approval of $1.9tn-worth additional fiscal stimulus and are back to 2013 levels. Thus far, the increase in real bond yields has not been as strong as during the 2013 *taper tantrum,* pricing in a still accommodative Fed.

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01

Inflation fertilisers at stake

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Main inflationary trends

1 Cyclical recovery

Following the Q1 contraction in Europe, the recovery should unfold from Q2, while the United States and China are at a more progressed stage. As demand recovers, cyclical inflation should accelerate.

2 Fiscal stimulus

The US House and Senate passed the Biden administration's $1.9tn stimulus bill. The Covid-19 crisis has resulted in a fiscal response of a different order of magnitude from previous crises. This could fuel inflationary trends.

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

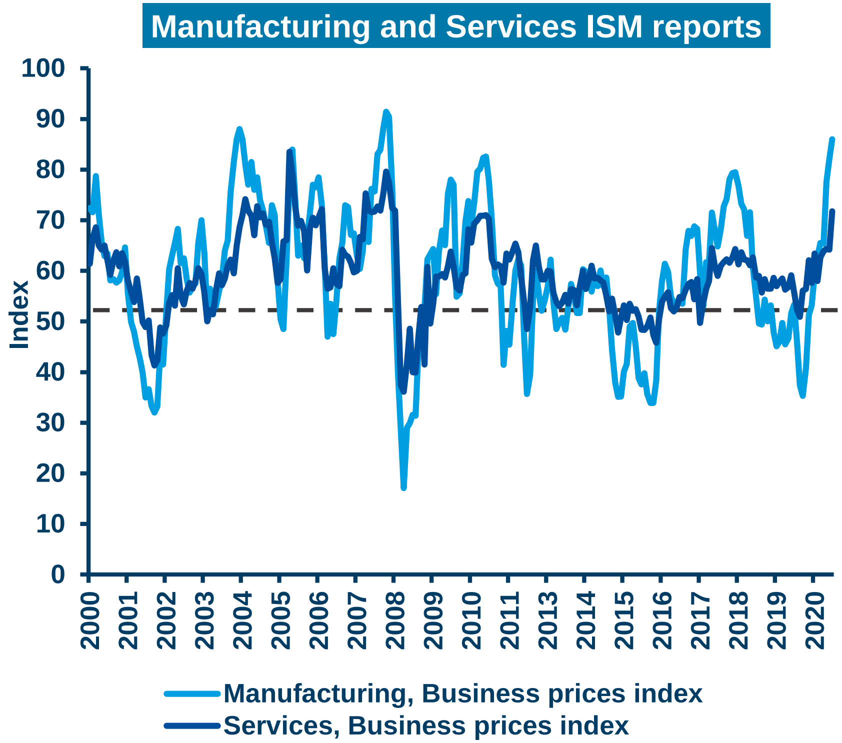
For the first time in over 30 years, market narratives are expressing a preference for inflation as a way out of the crisis and of the huge amount of debt accumulated. This will have key implications on long-term trends.

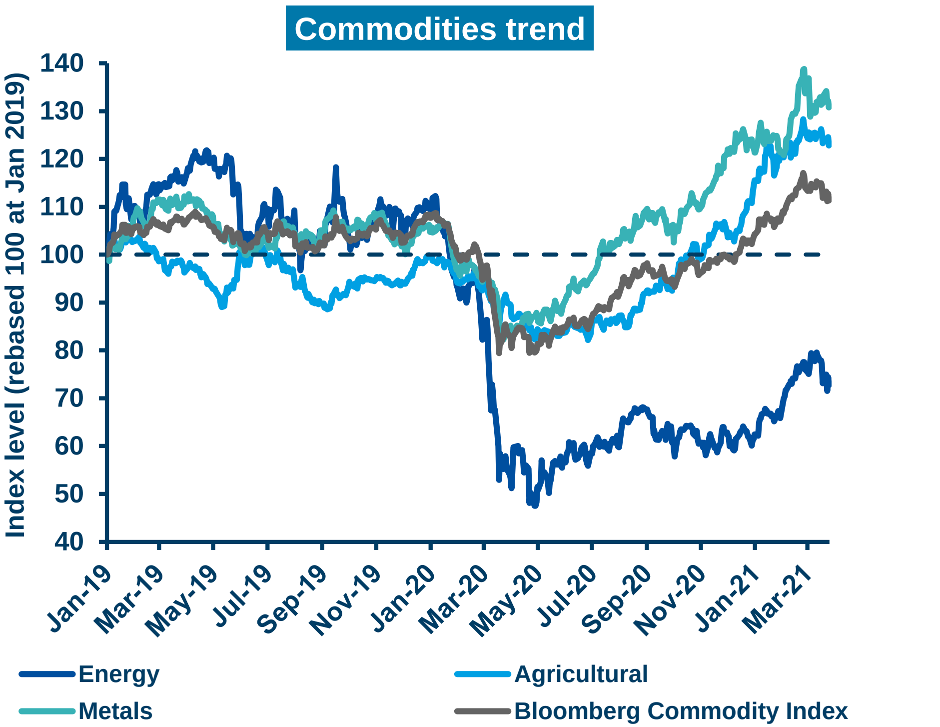
Next 12-24 months (items 1–3)

3-5 years (item 4)

Source: Amundi as of 25 March 2021.

Inflationary pressures are spreading around the economy





There is plenty of evidence of accelerating inflation trends. The March US ISM surveys found prices in both the manufacturing and services sectors at their highest levels since 2007 and rising fast. These have proven to be good leading indicators of inflation in the past. Meanwhile, commodity prices are accelerating and are generally higher than January 2019 levels.

Source: Amundi, Bloomberg. Data as of 4 March 2021,

Source: Amundi, Bloomberg. Data as of 25 March 2021.

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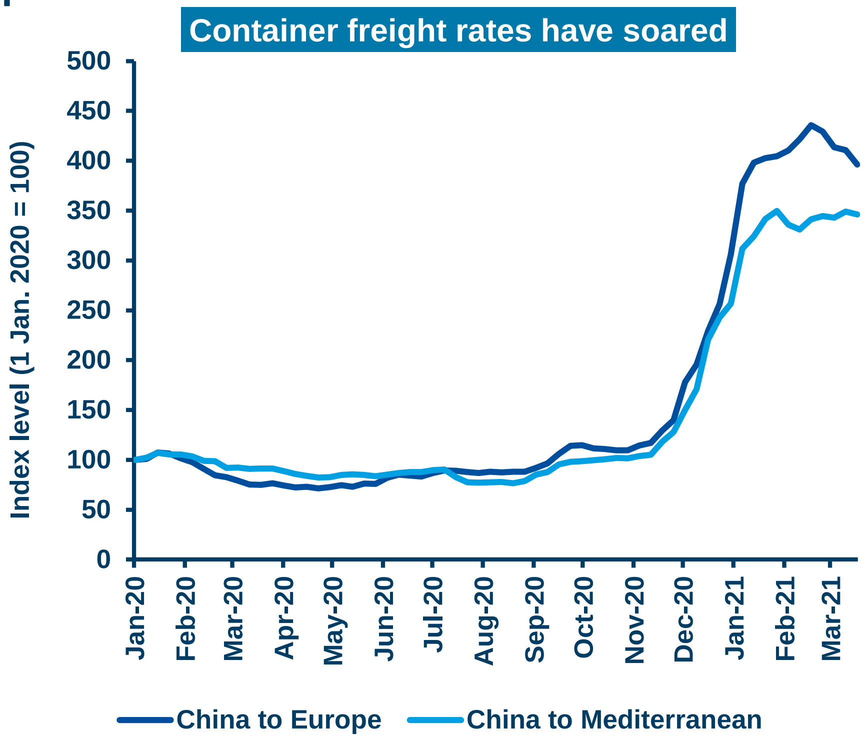
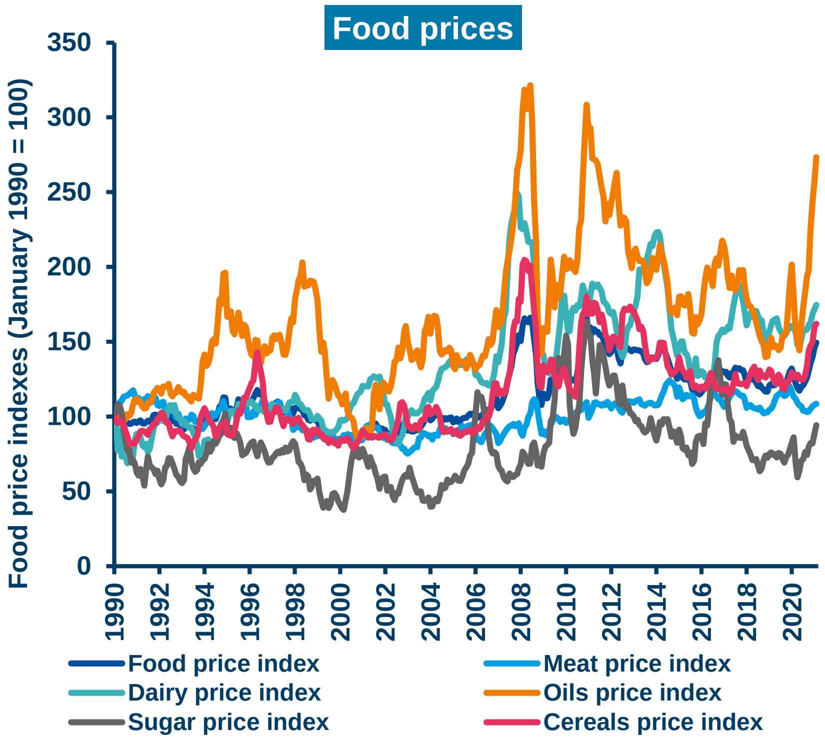
Soaring freight and food prices could lead to higher input prices





The cost of shipping goods from China to Europe has more than quadrupled over the past two months, due to the combination of a shortage of containers and a recovery in consumer demand. In addition, the price of some agricultural products has been rising sharply, especially vegetable oils and cereals. These costs may be passed on to end users, adding to accelerating inflation trends.

Source: Amundi, Bloomberg. Data as of 25 March 2021.

Source: Amundi, FAO. Data as of 25 March 2021.

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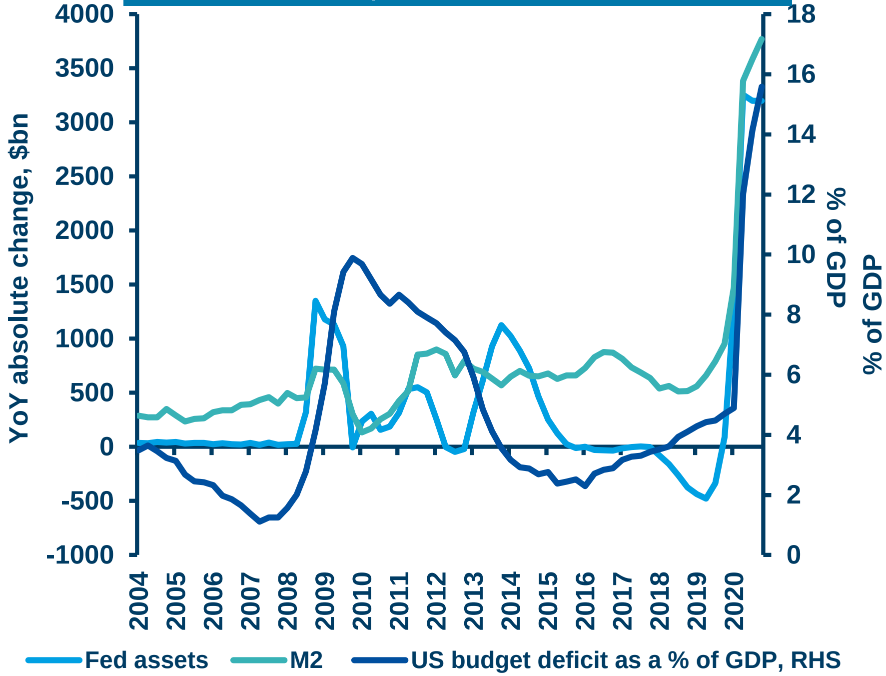
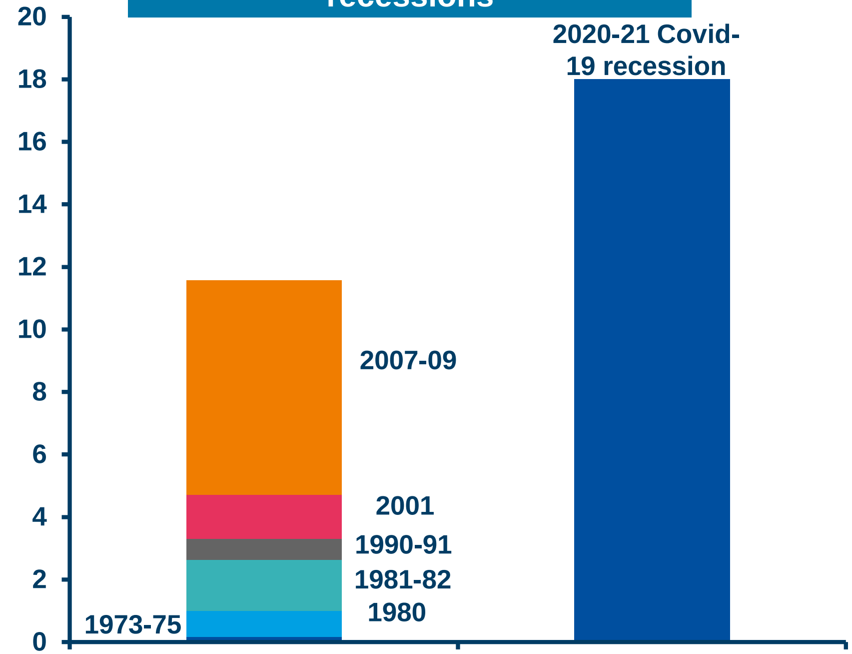
US fiscal stimulus is like no other in recent history

US fiscal deficit, M2 and Fed balance sheet



Increase in US budget deficit during recessions

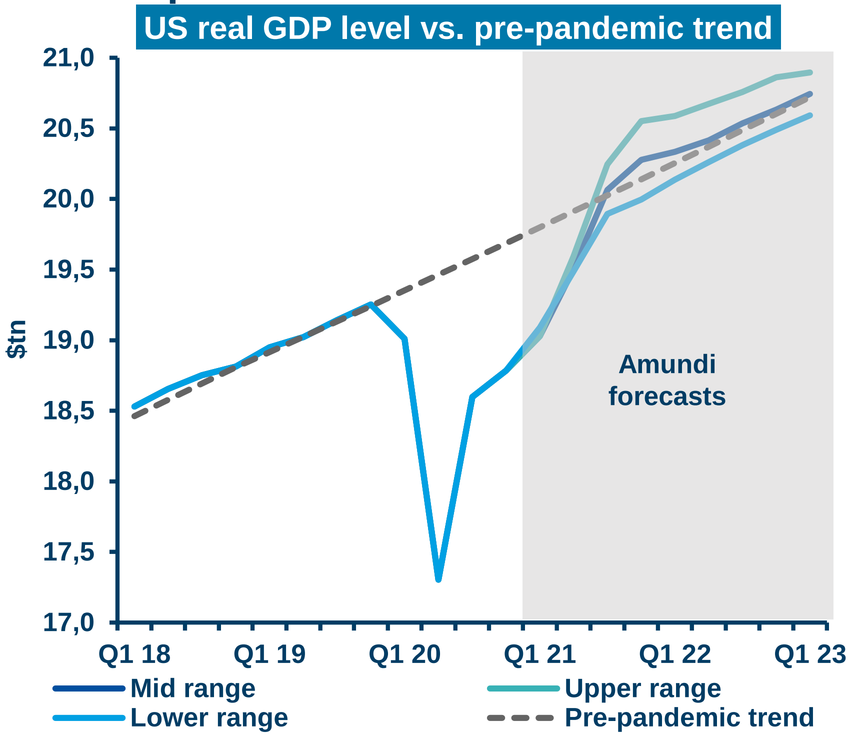


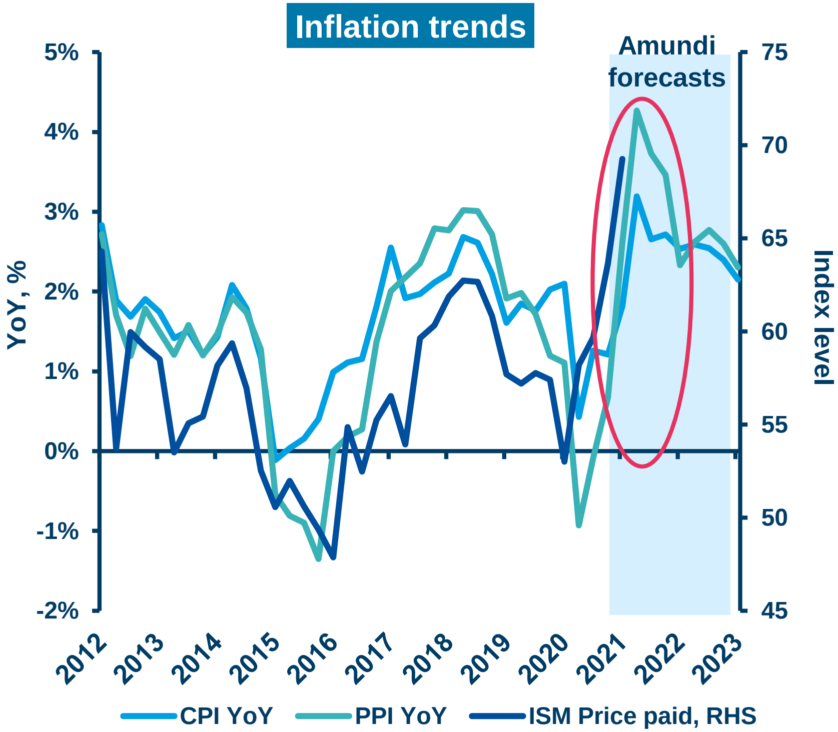
The fiscal stimulus deployed by the US administration to fight the Covid-19 crisis is of an unprecedented magnitude. Including the recently approved $1.9tn package, it will lead to a higher US budget deficit than the combined stimuli deployed over the previous six recessions.

Source: Amundi, Bloomberg. Data as of 12 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.

Quickly reabsorbed growth shortfall may translate into more persistent inflation

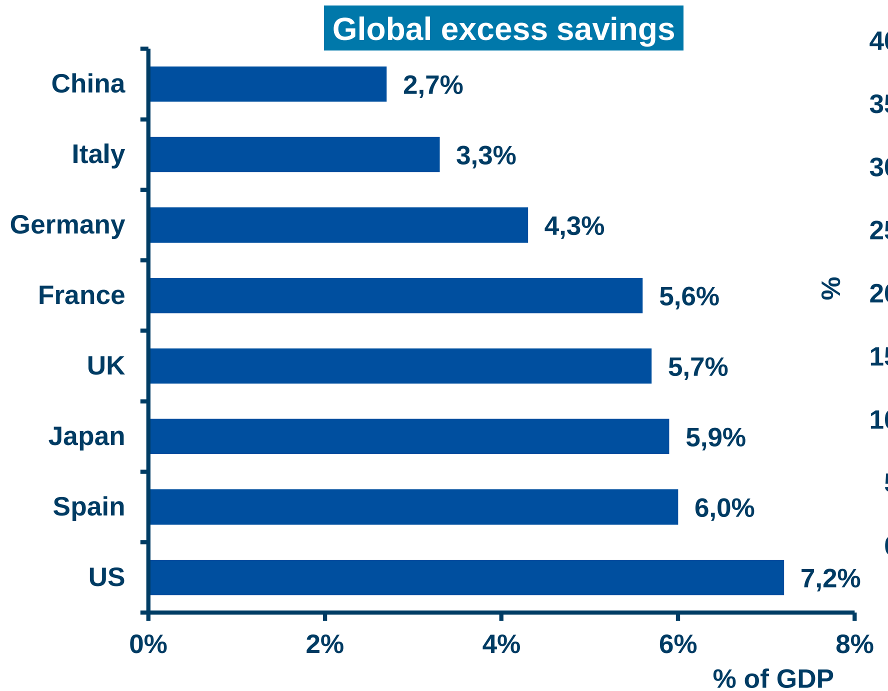


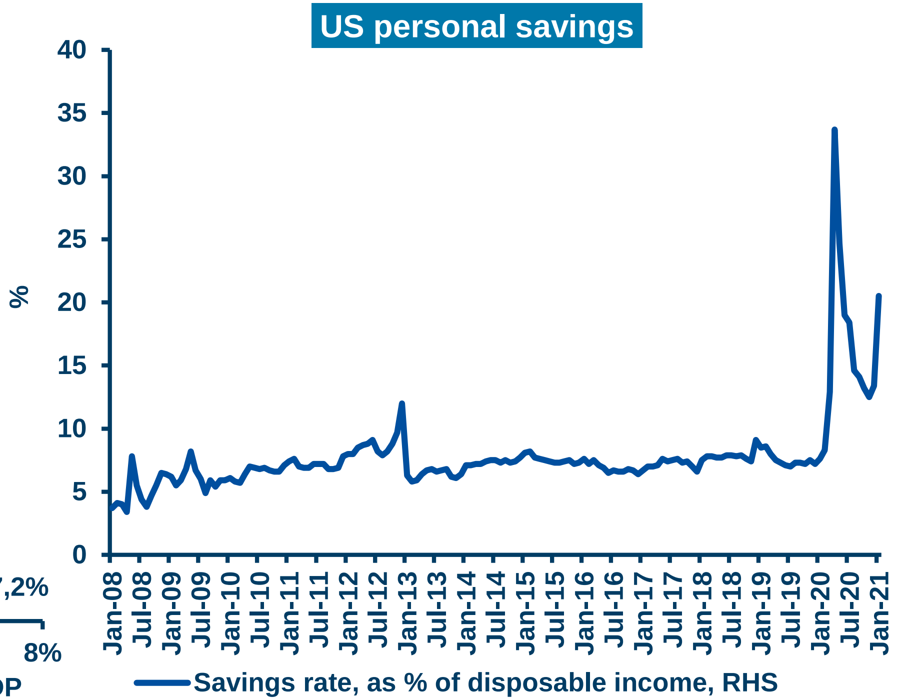


The $1.9tn fiscal package could lead to a quick acceleration of domestic demand from Q2 2021, with the output gap closing in late 2021/early 2022. This – on top of transitory factors at play over spring that will push inflation up – might help headline CPI inflation stabilise above 2%, while an overshoot in core PCE (Personal Consumption Expenditure) should be more limited both in terms of magnitude and persistence overtime.

Source: Amundi Research, Refinitiv-Eikon-Datastream. Data as of 12 March 2021. In line with the CBO, we assume that $1.2 tn will be delivered in FY 2021 and an additional $200bn in Q4 2021. The lower–range scenario is projected using an average fiscal multiplier of 0.45, while the upper-range one with a 0.7 multiplier, to provide a range of possible outcomes on GDP boost, considering that the fiscal multiplier varies according to the output gap and social distancing measures (e.g., lower with output gap, yet higher with less social distancing)

Part of the excess savings could result in higher demand once the pandemic is over





Globally, excess savings have spiked among higher-income households with fewer spending options available; this could support private consumption and asset price valuations.

Source: Amundi, Bloomberg Economics. Data as of 4 March 2021. Excess savings is computed as the difference between current savings and what would have resulted from a projection of past trends.

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

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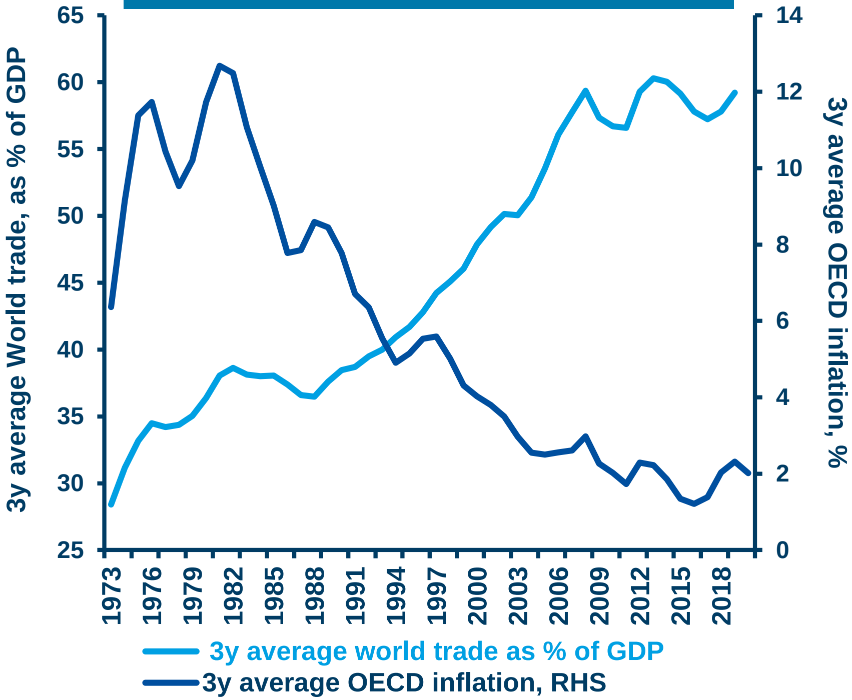
Long-term inflation seeds are here: de-globalisation, supply chain disruption

Food supply chain challenged by global lockdown along all its parts

Global trade and OECD inflation trends

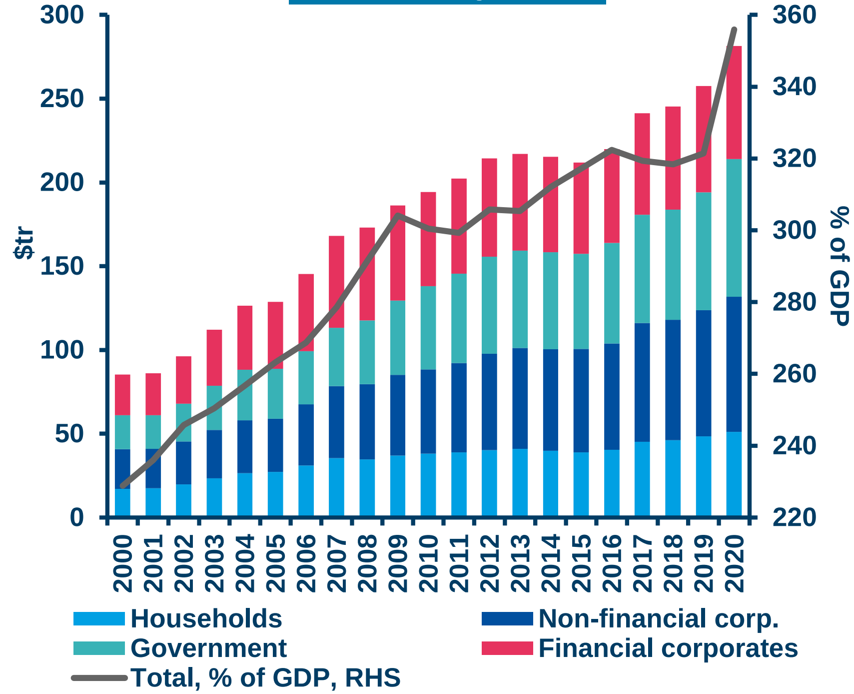


» Food prices are rising quickly. The disruption of supply chains due to the lockdowns is leading to a regionalisation of trade dynamics compared to global ones. The environment is more friendly for regional relationships than for broader globalisation.

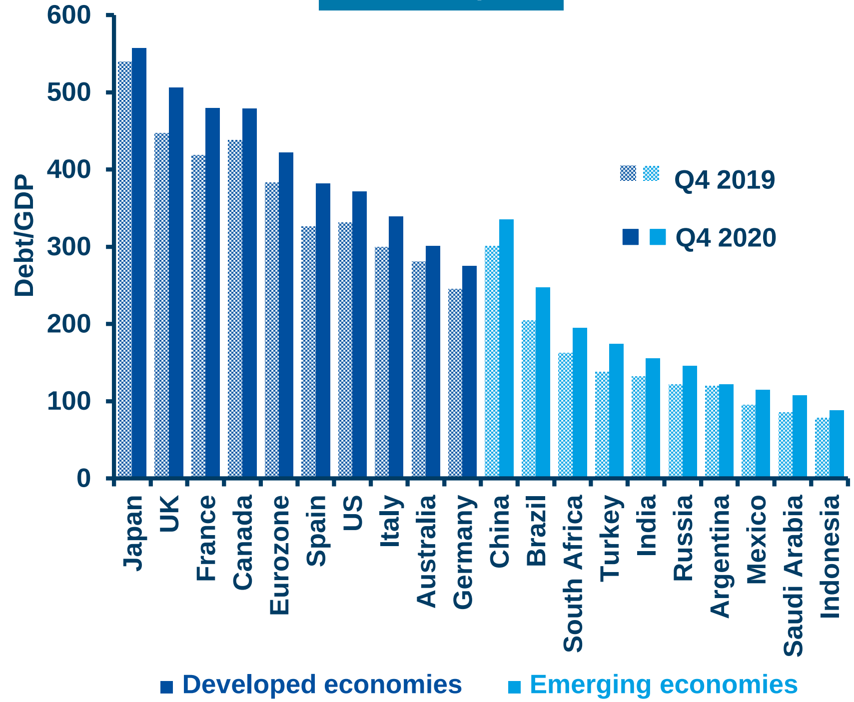
Source: Economic Policy Institute. Analysis of unpublished Total Economy Productivity data from Bureau of Labor Statistics (BLS) Labor Productivity and Costs programme, wage data from the BLS Current Employment Statistics, BLS Employment Cost Trends, BLS Consumer Price Index and Bureau of Economic Analysis National Income and Product Accounts. Notes: Data are for compensation (wages and benefits) of production/non-supervisory workers in the private sector and net productivity of the total economy. “Net productivity” is the growth in the output of goods and services less depreciation per hour worked. Data as of 25 March 2021. **Picture on the left is from FAO.**

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

Total debt by sector



Total debt/GDP

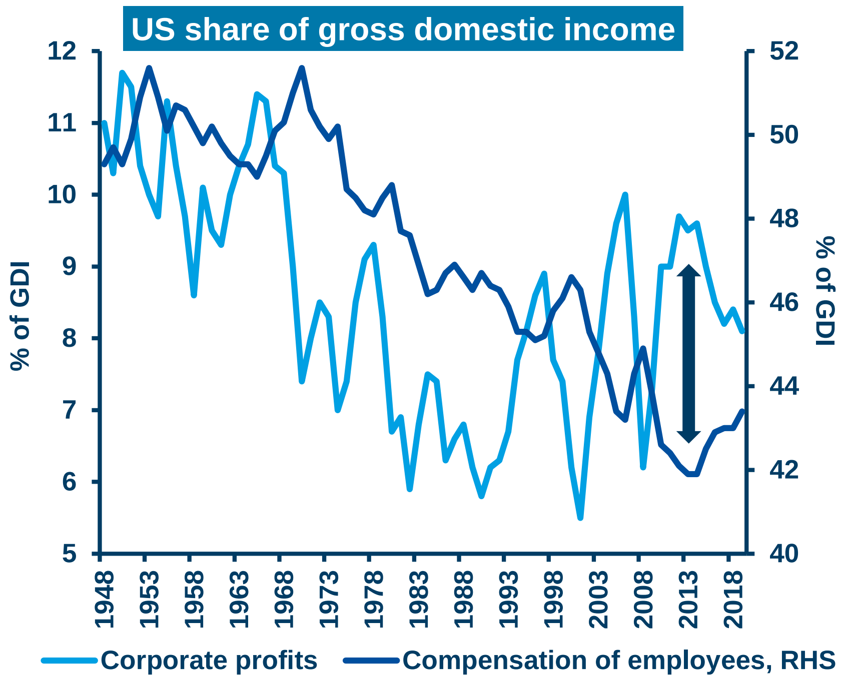


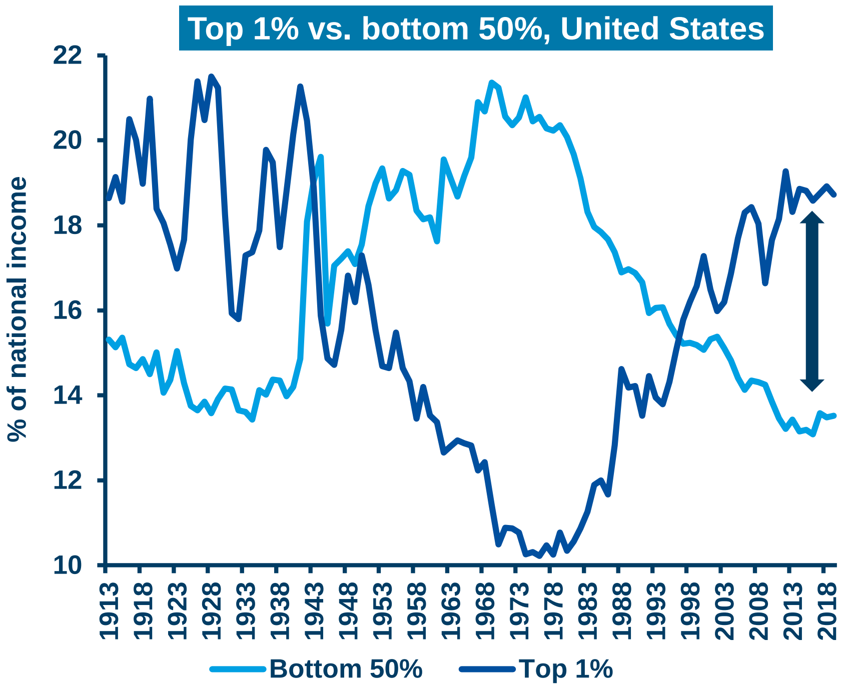
The total debt-to-GDP ratio spiked in 2020, approaching 360% of GDP at a global level. Such an increase occurred across different sectors, with governments and corporates contributing the most, and hinges on the cost of the pandemic and the recession. This ratio is now higher than it was one year ago across both DM and EM.

Source: Amundi elaboration on IIF data, as of 22 February 2021. Note: Total debt is the sum of government debt, household debt, financial sector debt and non-financial corporate debt.

Source: Amundi elaboration on IIF data, as of 22 February 2021. Note: Total debt is the sum of government debt, household debt, financial sector debt and non-financial corporate debt.

A rebalance is needed between labour and capital and to fight inequality





The Biden administration could pursue policies aimed at accelerating a rebalancing of income share in favour of labour and a 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.

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02

Investment: how to deal with higher inflation

Investment ideas for inflation-proof portfolios

Bonds

- Short and active on duration
- Inflation-linked bonds
- Floating-rate notes
- Securitised assets
- Beyond benchmark approaches

Equities

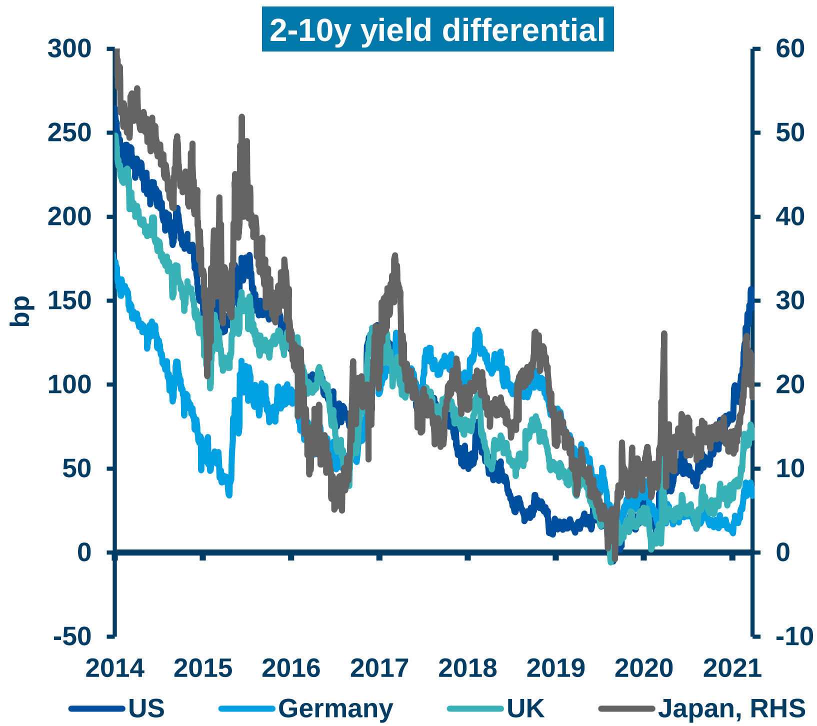
- Multi-year rotation towards value stocks
- Caution on highly interest-rate-sensitive stocks (hyper-high growth)
- High dividend stocks

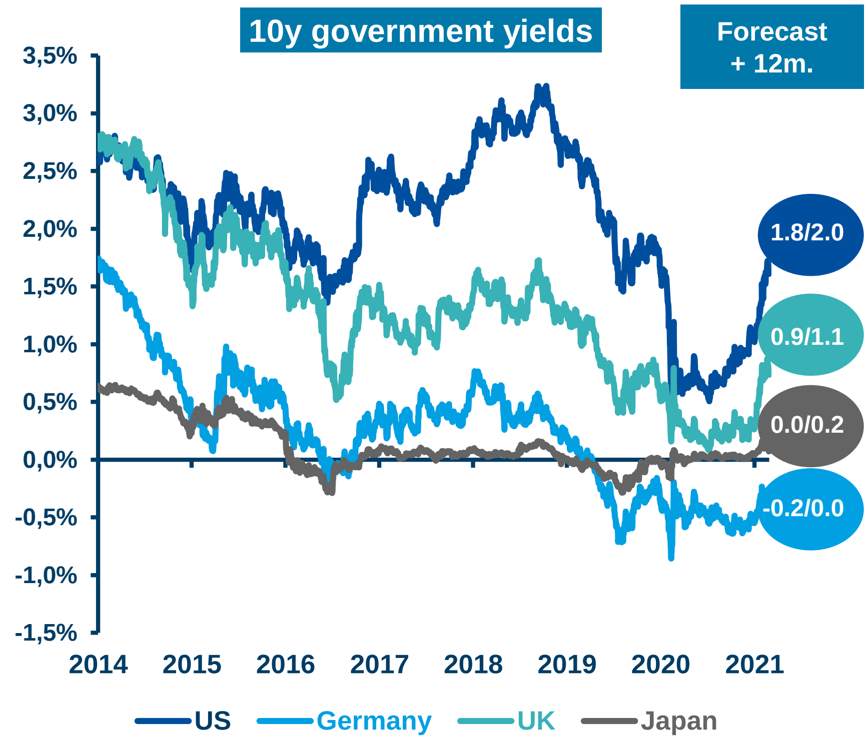
Cross-assets

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

Source: Amundi, as of 25 March 2021.

Bonds: caution on duration with flexibility





The US yield curve has been steepening amid expectations of strong fiscal stimulus, economic recovery and inflation. Such movement has been reflected at the global level, where issuers have increased the duration of issues to take advantage of low rates. Against such a backdrop, investors should stay cautious, but active, on duration and rate movements.

Source: Bloomberg. Data as of 25 March 2021.

Source: Bloomberg. Data as of 25March 2021. Forecasts by Amundi Research as of 25 March 2021,

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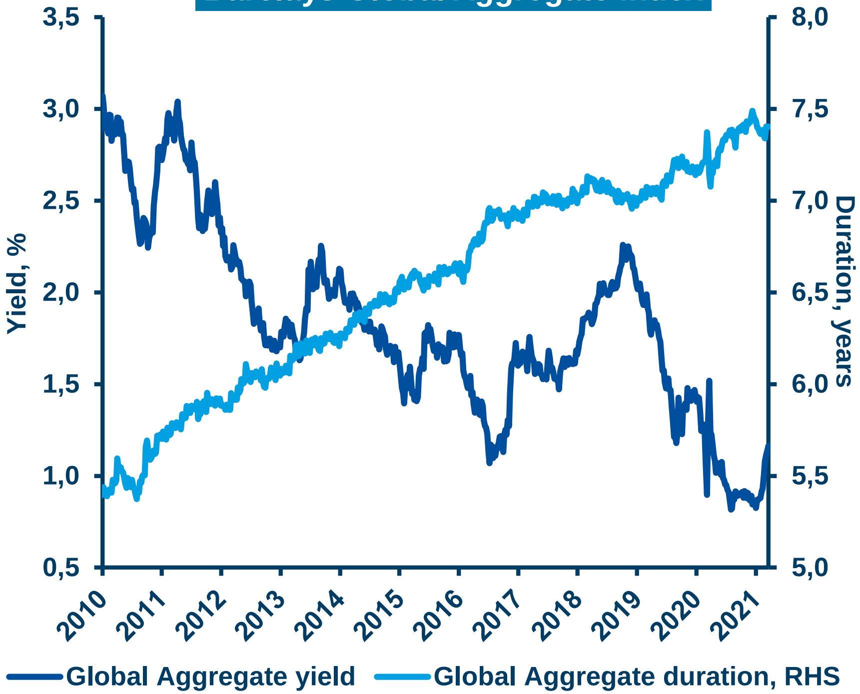
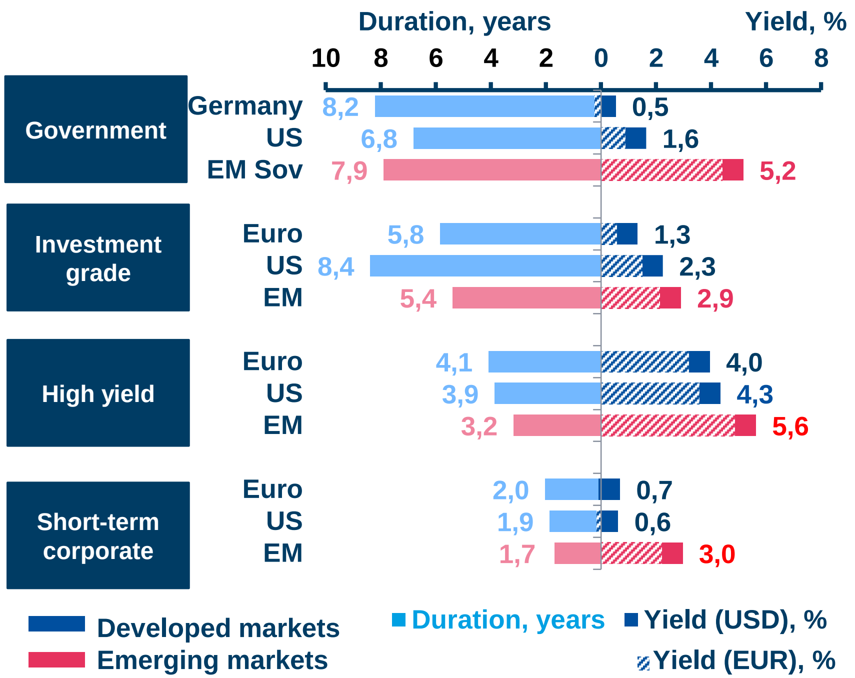
Beyond traditional global benchmarks with a flexible approach

Bonds



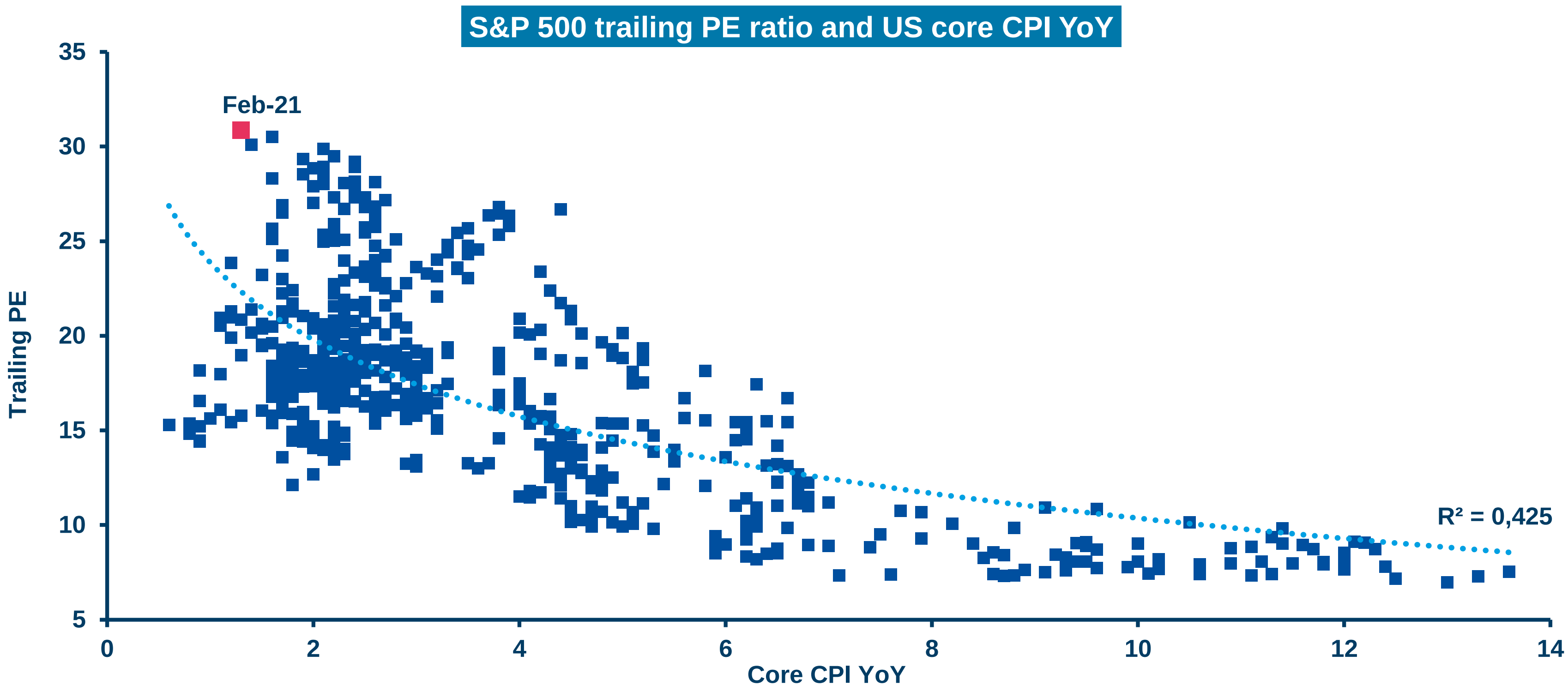


Nowadays traditional benchmarks hold significant duration risk, with low implicit yields. Investors should go beyond them and get exposure to different sources of return, with an unconstrained approach that may help limit duration risk (inflation-linked bonds, securitised credit, floating-rate notes).

Source: Amundi analysis on Bloomberg data as of 25 March 2021.

Source: Amundi analysis on Bloomberg data as of 25 March 2021.

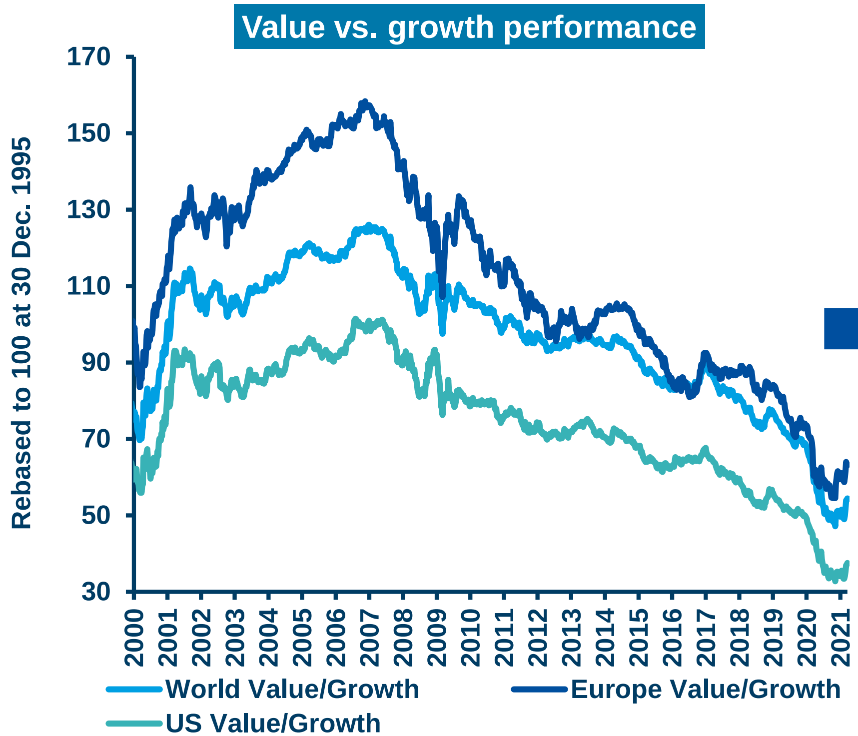
Equity: higher inflation may challenge high valuations

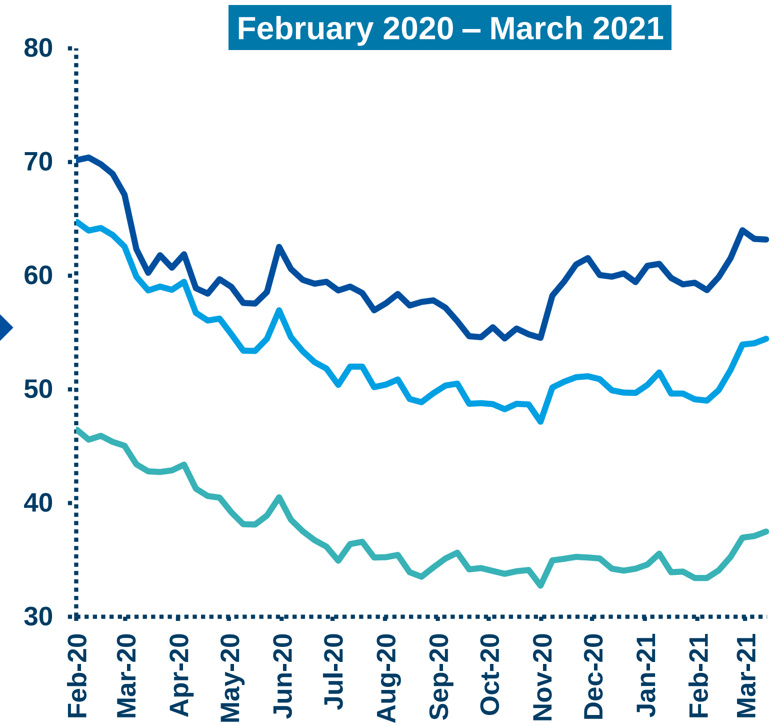


As the Fed is now targeting average inflation over a time horizon, the inflation acceleration could prove persistent. High and sticky core inflation may dent equity valuations, which are now at expensive levels.

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

Higher inflation supports the multi-rotation towards value





» Recovery and reflation hopes buoyed the performance of value stocks compared with growth stocks, as we believe this rotation is a long-term trend. This should be facilitated by the excessive valuations of growth stocks relative to history.

Source: Amundi, Bloomberg. Data as of 25 March 2021.

Source: Amundi, Bloomberg. Data as of 25 March 2021.

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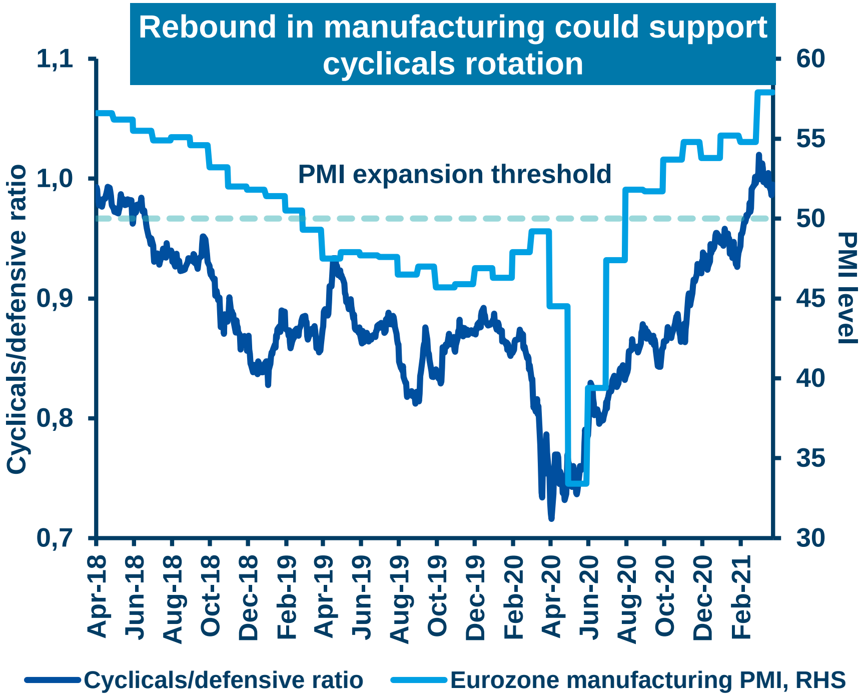
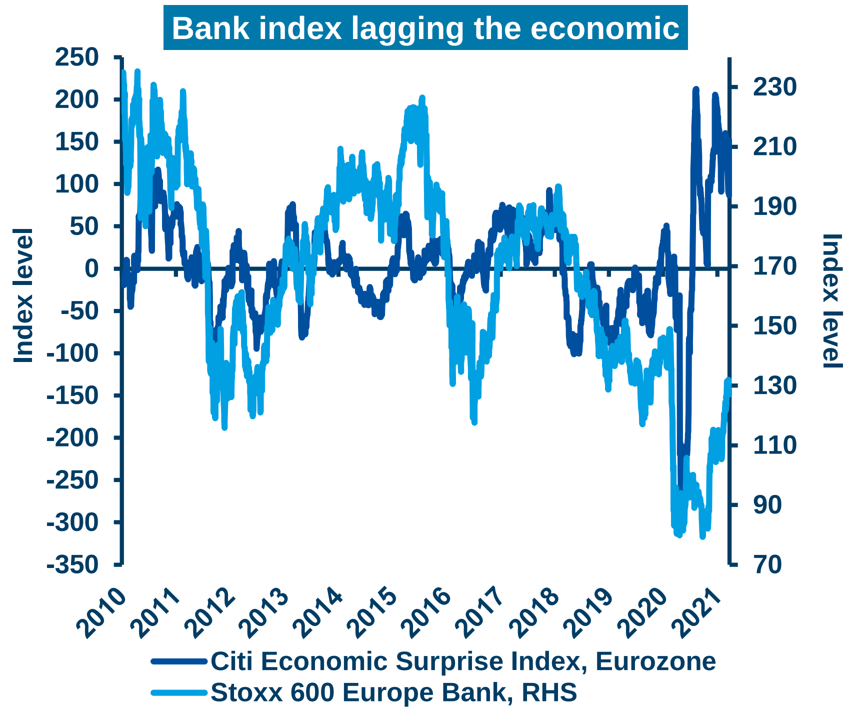
EU: cyclicals may continue to rise higher, banks and financial are leading the new leg of rebound





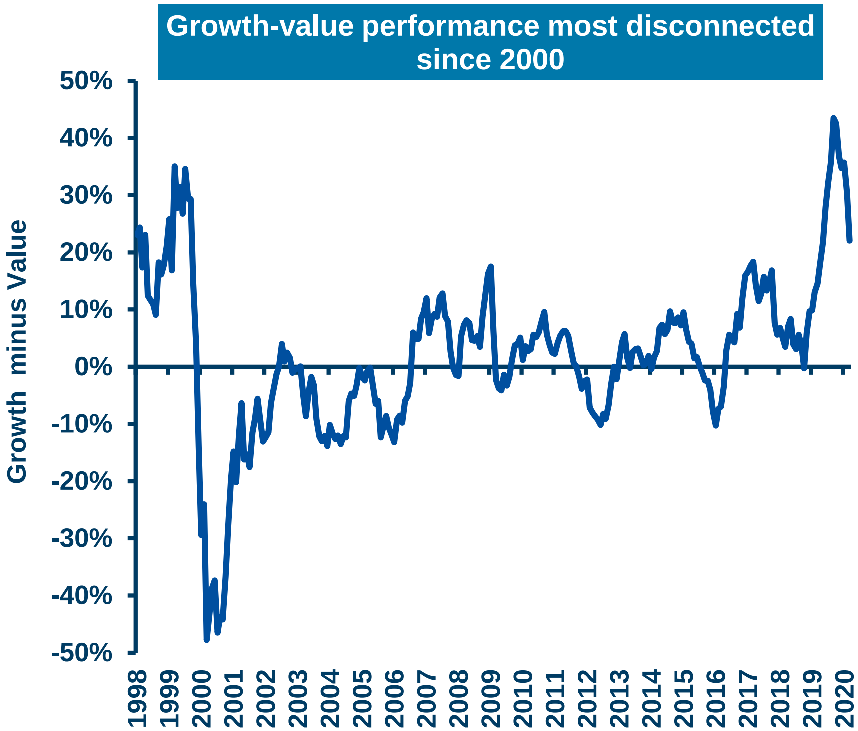
» Improvements in manufacturing and the overall economy are likely to benefit sectors more closely linked with this recovery. However, this rebound will not lift all boats. Instead, businesses that display strong earnings potential and sectors, such as banks -- that have been left behind in the rebound so far -- are likely to gain. However, investors should look at specific business models and remain selective.

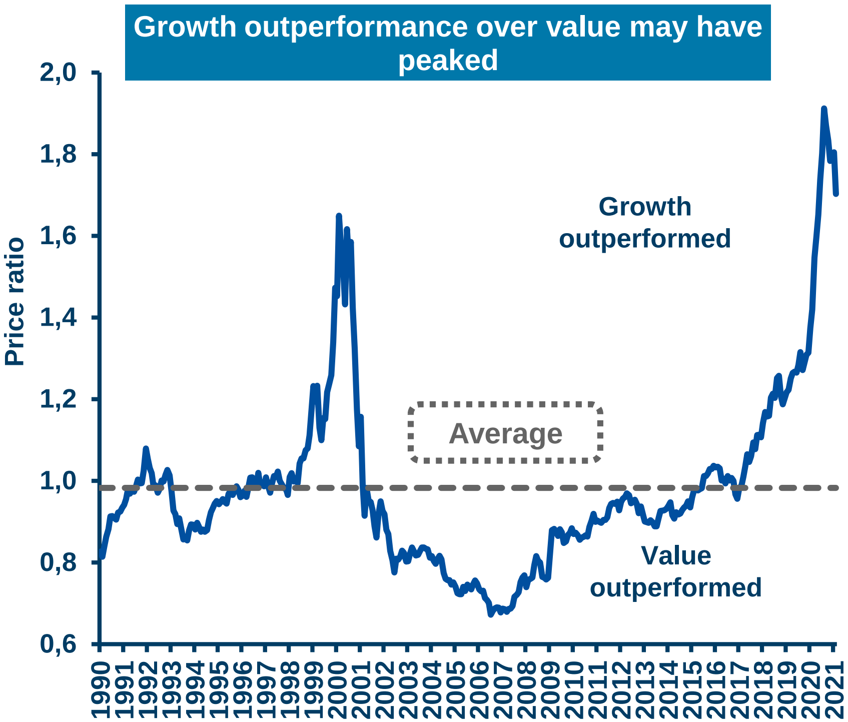
Source: Amundi, Bloomberg. Data as of 12 March 2021. Stoxx Europe 600 C/D ratio.

Source: Amundi, Bloomberg, as of 25 March 2021. Stoxx Europe 600 Banks.

Equities

US: time for value is now



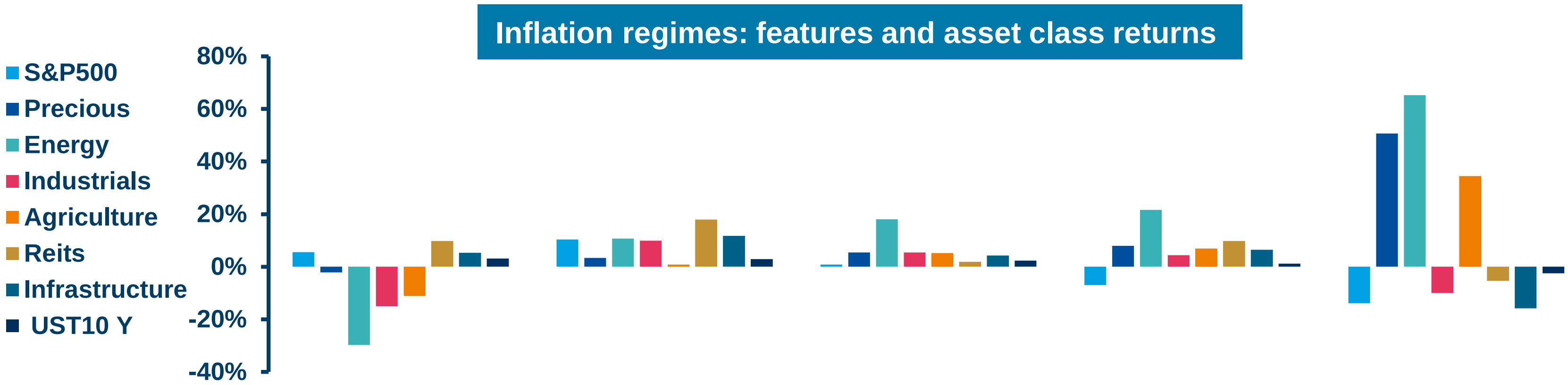


» Over the past ten years, growth stocks have outperformed value stocks due to the prolonged period of low interest rates and weak GDP growth. This is about to change and growth appears vulnerable, while value is promising. US value provides a unique combination of structural growth, quality, ESG improvement, stability, and defensiveness.

Source: Amundi, Bloomberg, as of 28 February 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 28 February 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.

Different asset class behaviours under different regimes



Inflation Regimes	Deflationary regime	Normal	Inflationary regime	Hyperinflationary recovery	Hyperinflationary 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
Unit labour cost YoY (%)	<1	2-3	3-6	6-9	>9

We have analysed asset class behaviours between 1960 and 2018, during different inflation regimes. In the ‘70s, equities delivered poorly, while commodities -- especially precious metals -- were the most remunerative assets.

Source: Amundi Research. Data as of 17 April 2020. S&P 500, US global REITS from global financial data; US T10yrs from Bloomberg; global infrastructure (equities): total returns series proxied by a basket of 50% utilities and 50% transportation; precious metal: GSCI Precious Metals Total Return Index, proxied by gold before index starts; Energy: GSCI Energy Total Return Index, proxied by Brent Crude Oil before index starts; Industrial metals: GSCI Industrial Metals Total Return Index, proxied by copper before index starts; Agriculture: GSCI Agriculture Total Return Index.

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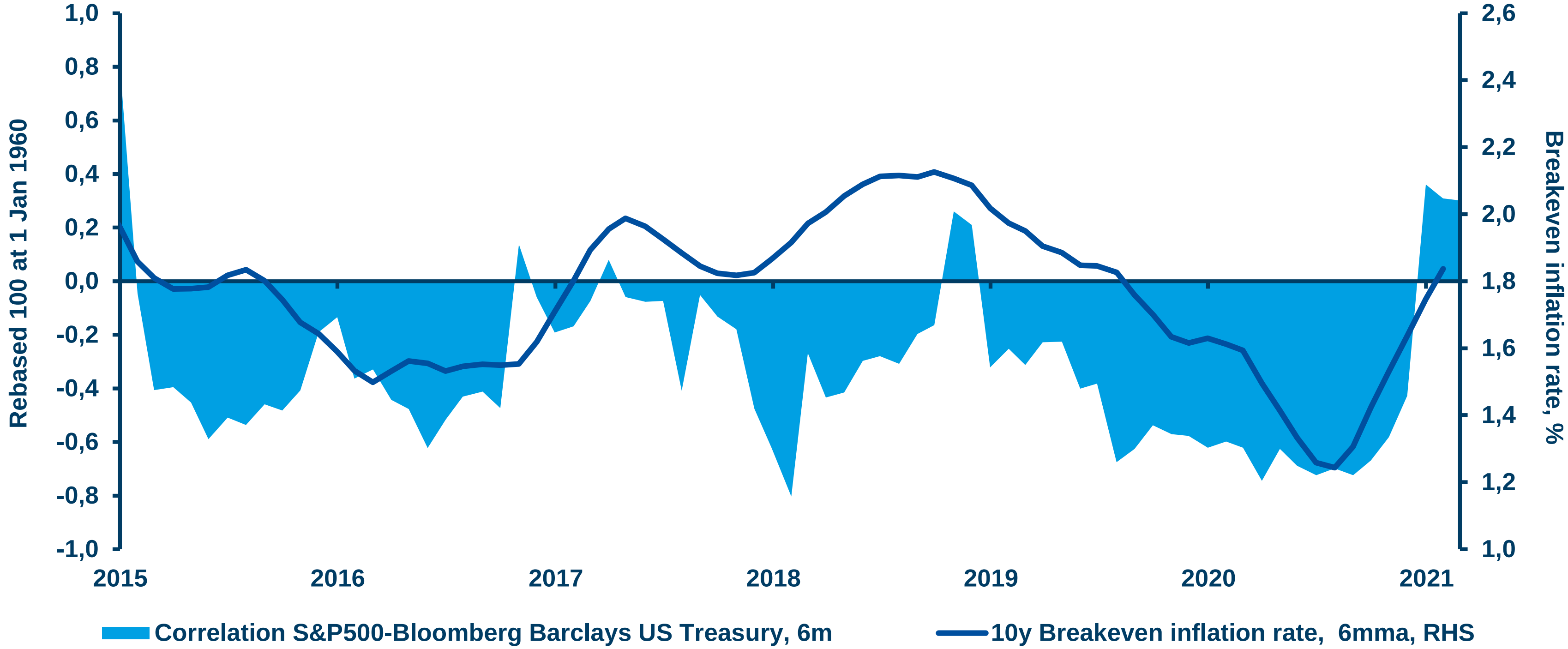
Bond-equity correlation tend to turn positive with rising inflation expectations



In a rising inflation environment, traditional bond/equity negative correlation might be challenged. Investors should seek to enhance diversification into assets that would be more resilient to higher inflation. In this respect, real assets -- such as real estate, infrastructure and absolute return strategies -- will be helpful tools.

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

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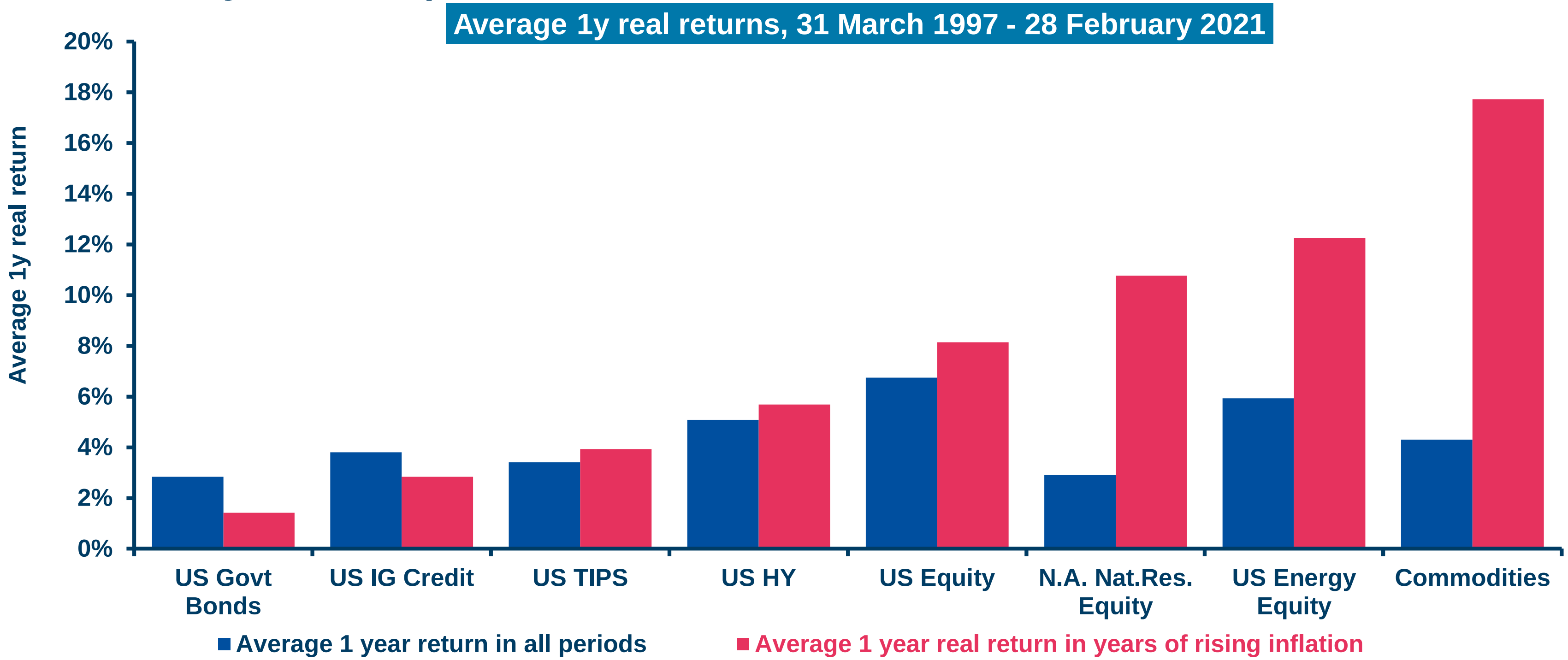
TIPS, commodities and equity sectors linked to the real economy have performed well when inflation rises



» In a rising inflation environment, government bonds and IG credit tend to underperform, while TIPS and US HY out-perform. 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.

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“Cyclical and structural forces are playing in favour of higher inflation compared to the previous decade. Investors should make themselves ready now and build inflation-proof portfolios. ”

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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.

Amundi ASSET MANAGEMENT

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