February 2022

Inflation is starting to burn
Strategies to protect portfolios from inflation risk

Confidence must be earned
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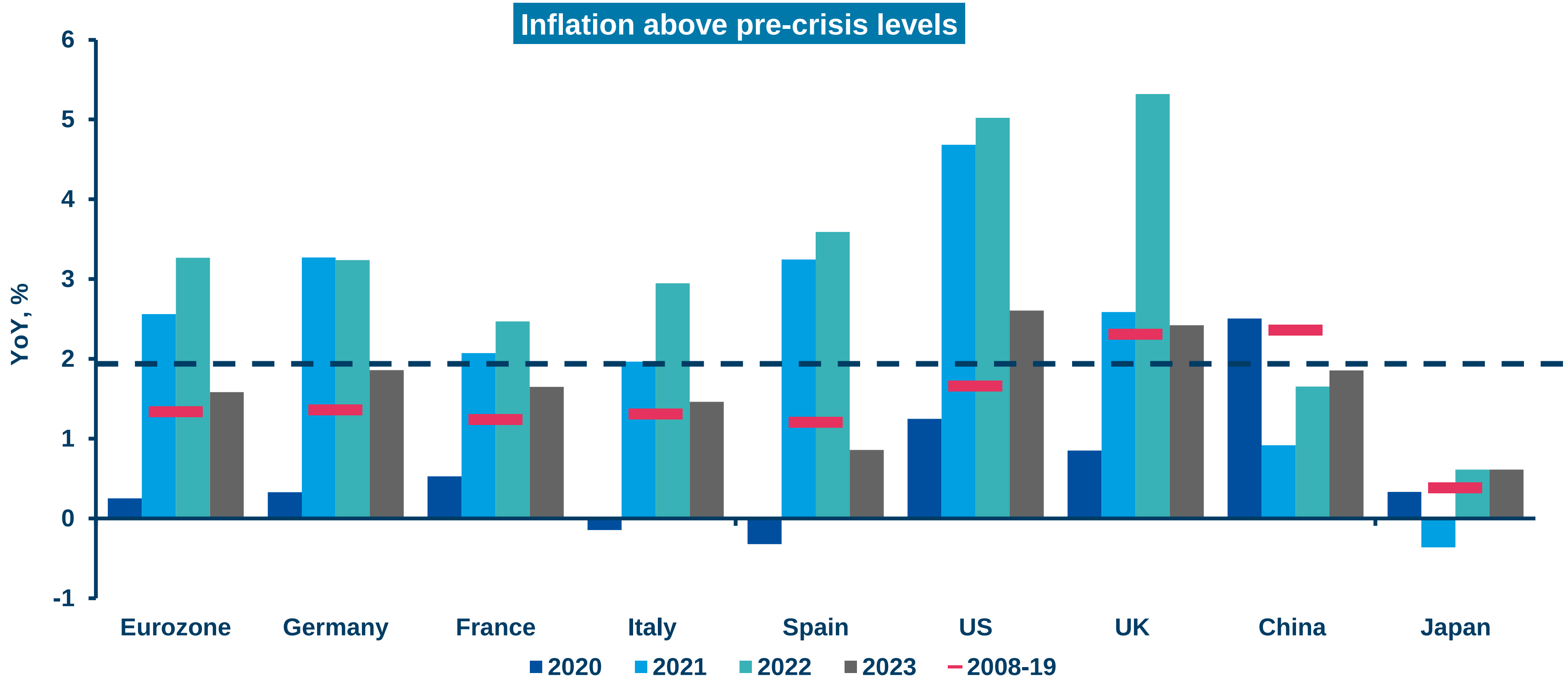
Investment Insights | Market Stories

Persistent inflation, above pre-crisis levels, except for China



Inflationary pressures should prove persistent in 2022, especially early in the year. We expect US CPI to be 5.0% on average and the Eurozone's should remain well above 3.0% this year. China's situation is different though, as CPI slowed to 0.9% YoY in 2021 and should only accelerate mildly in 2022.

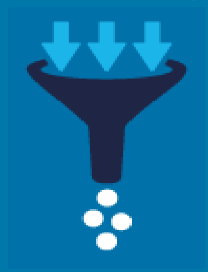
Source: Amundi Research. Data is as of 31 January 2022. Forecasts are by Amundi Research and are as of 21 January 2022. CPI: consumer price index, average % YoY growth.

01

A new inflation regime

Main factors boosting inflation, not all priced in already

1 Supply-chain bottlenecks and PPI-CPI pass through



2022

Soaring shipping costs and global supply-chain disruptions will keep inflation elevated in 2022. This trend will join forces with the ongoing re-shoring wave, restrictive trade policies and geopolitical tensions that may exacerbate price pressures. Another inflation leg could come from producer prices passing through to consumers.

2 Laggard indicators of strong demand

2022

The ongoing labour market recovery and wealth effect due to booming housing market – especially in the United States – should keep consumption strong. Strong demand for housing will boost shelter costs.

3 Psychological dimension not yet priced in

2022-23

Inflation has a critical psychological dimension that depends on forces of memory and forgetfulness. Persistent inflation data could revive long-term memory patterns (similar to the 1970s) and activate the inflationary process back into the real sphere over the next couple of years.

4 Structural factors: *greenflation*

Long run

Structural factors such as the energy transition will add to inflationary trends in the medium/long run. This, coupled with the still limited production capacity of renewable energy and high demand for commodities needed in the transition, will push up energy bills and boost green transition-related commodity prices.

Source: Amundi as of 31 January 2022.

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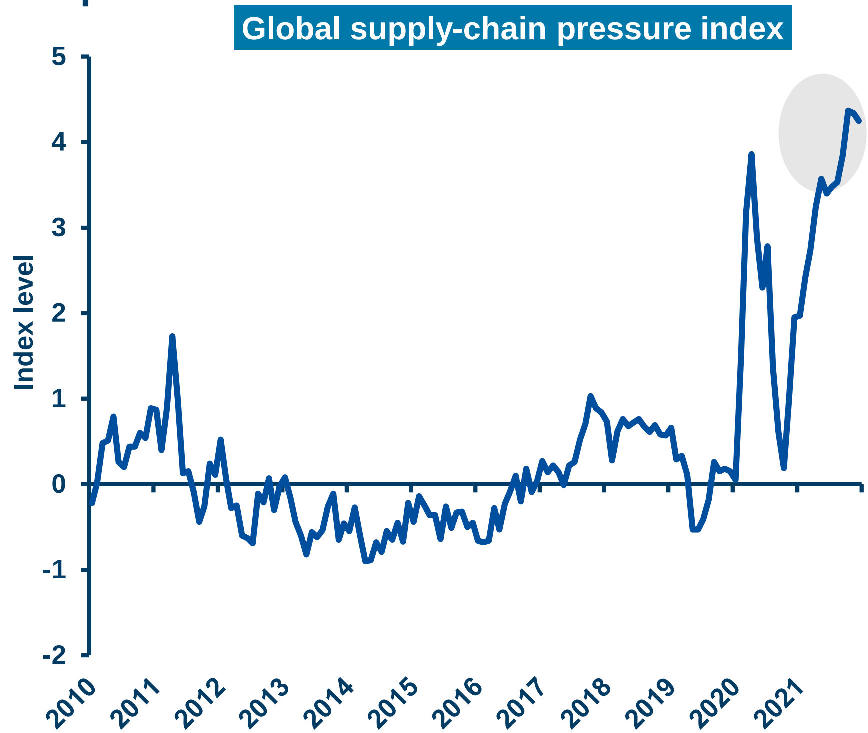
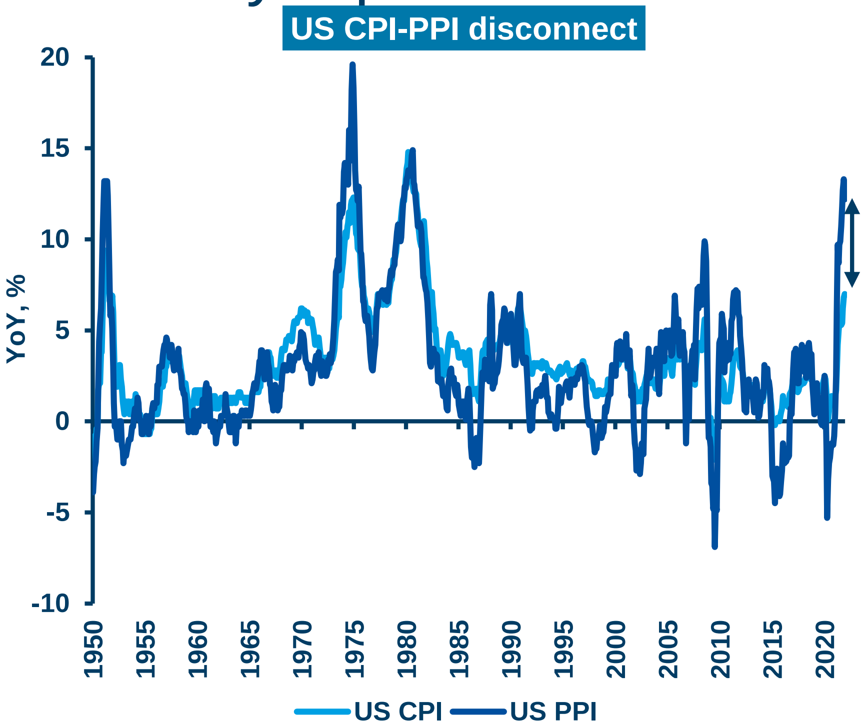
Supply-chain bottlenecks remain elevated, pass-through of production costs to consumers not yet priced in



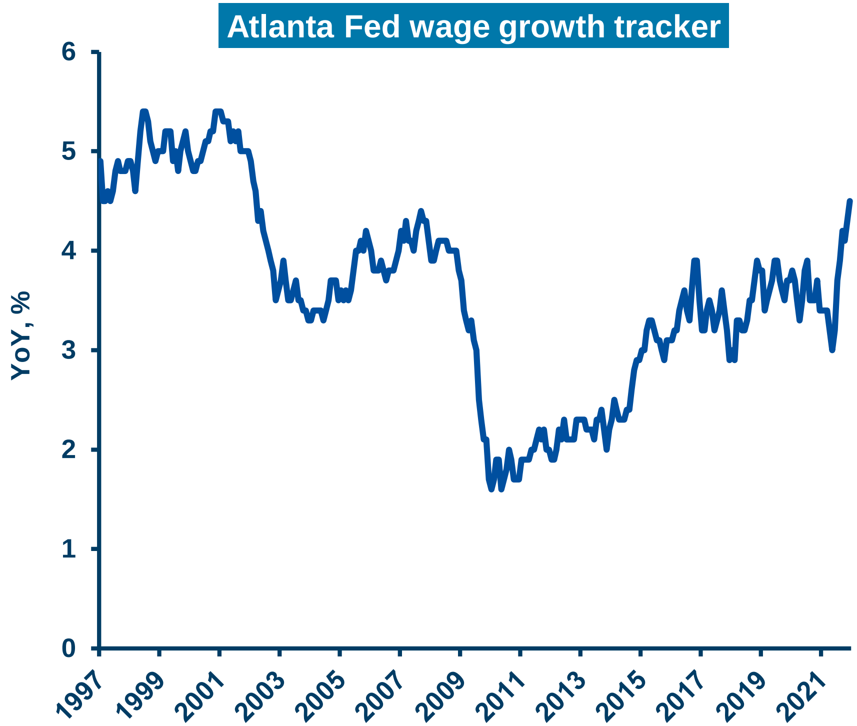


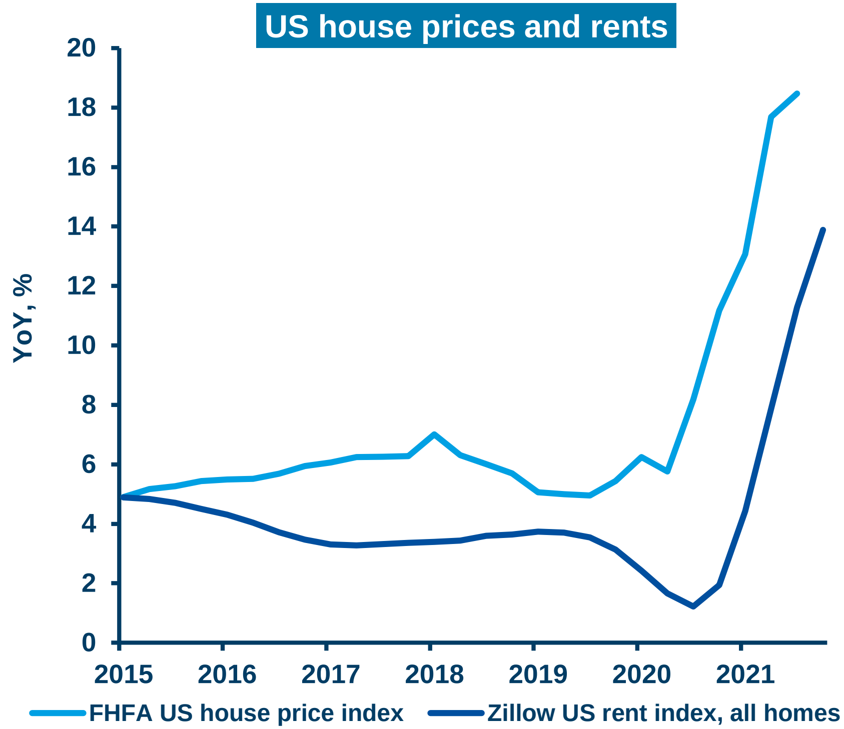
Global supply-chain disruptions are at historic levels, keeping shipping costs upbeat. In the United States, high producer prices have not yet been passed into consumer prices entirely. If firms can do so – and enjoy strong pricing power – US CPI might accelerate further.

Source: Amundi, Bloomberg. Data is as of 28 January 2022.

Source: Amundi, Bloomberg. Data is as of 28 January 2022.

Strong wage growth and house wealth effects should drive demand





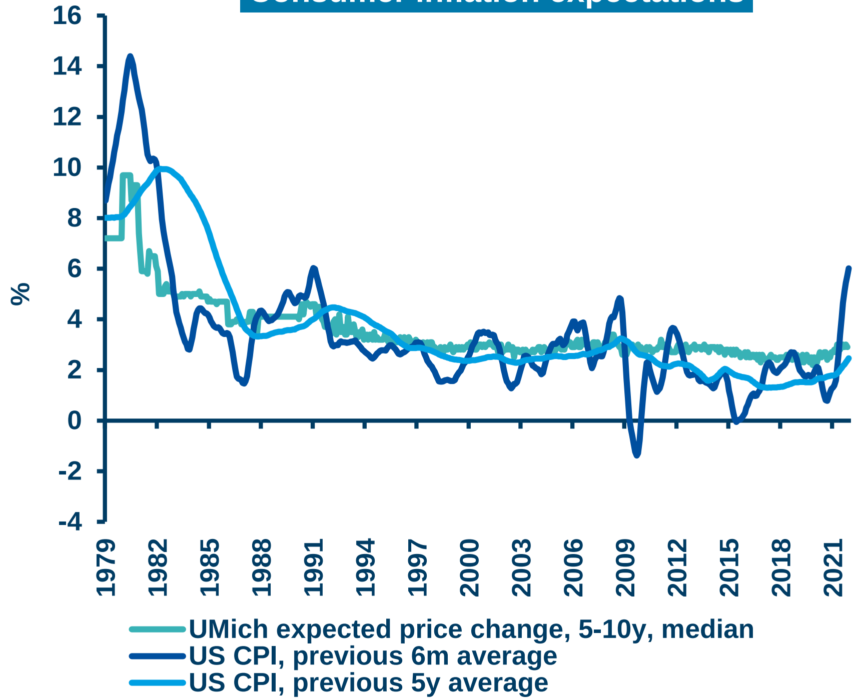
Wage growth is materialising. The adverse wage-inflation loop is a key risk to watch. Private demand could be supported further by the wealth effect from the booming housing market. The US real estate market is benefitting from tight house inventories and strong demand, as US household wealth soared during the Covid-19 crisis.

Source: Amundi, Bloomberg. Data is as of 28 January 2022. The Atlanta Fed's wage growth tracker is a measure of the nominal wage growth of individuals. It is constructed using microdata from the Current Population Survey and is the median % change in the hourly wage of individuals observed twelve months apart.

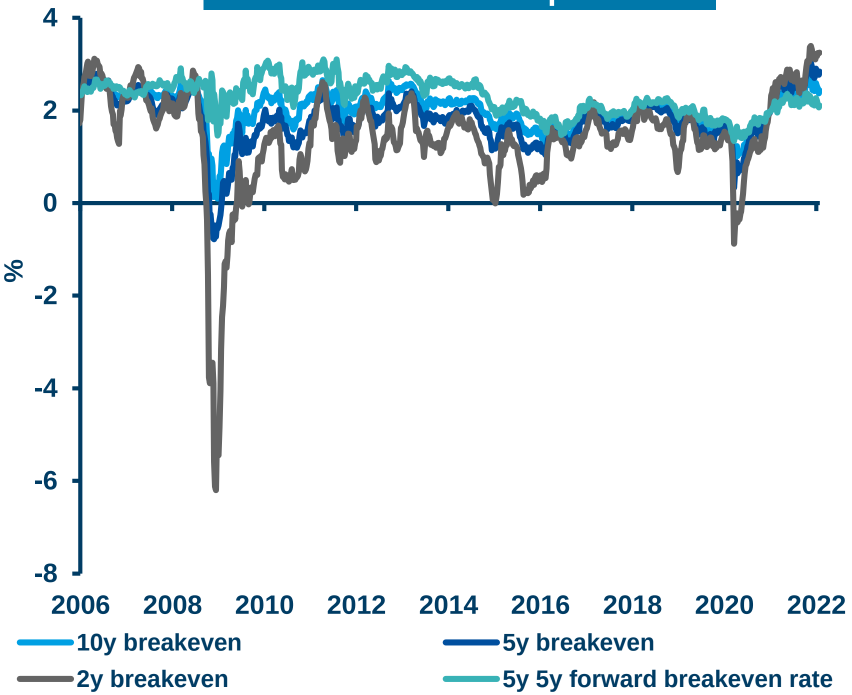
Source: Amundi, Bloomberg. Data is as of 31 January 2022.

Medium-term expectations remain anchored, but persistent inflation may undermine this trend

Consumer inflation expectations



US market inflation expectations

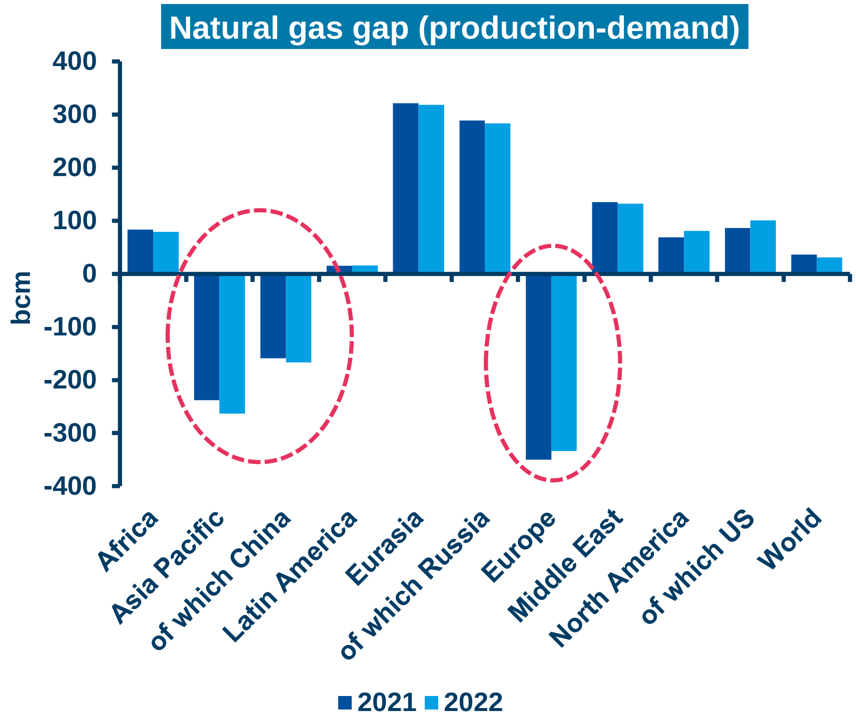


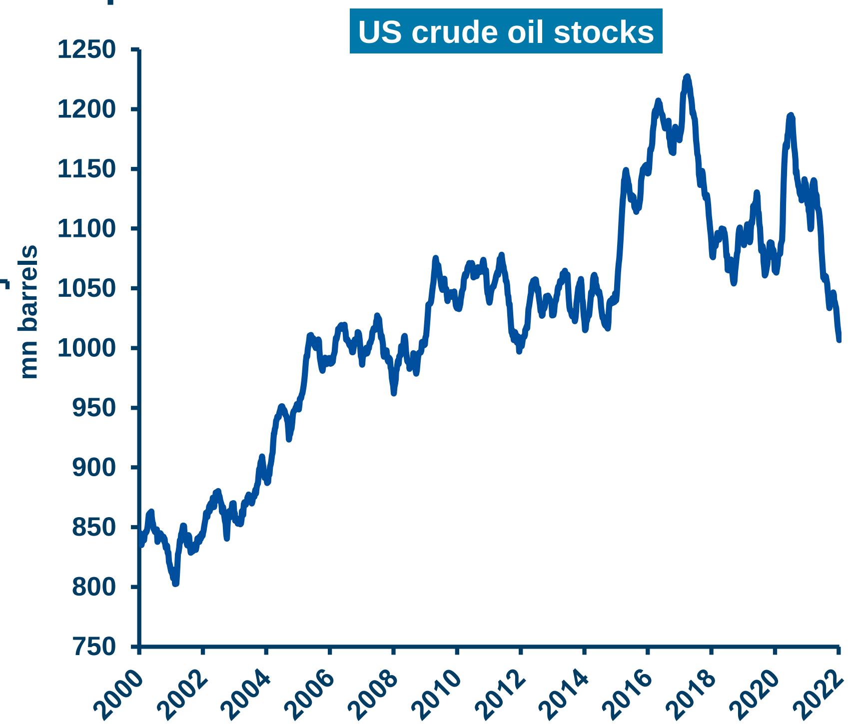
Consumer inflation expectations for the next five/ten years (green line) have been aligned to medium-term average inflation levels (five-year average, light blue line). In some phases, they have also been driven by short-term inflation trends (six-month average, dark blue line). A sudden shift – as shown by the most recent data – can revive some long-term memory patterns and activate the inflationary process.

Source: Amundi calculations on Bloomberg data. Data is as of 28 January 2022.

Source: Amundi, Bloomberg. Data is as of 28 January 2022.

Supply-demand imbalances and geopolitical factors are putting the energy sector under pressure





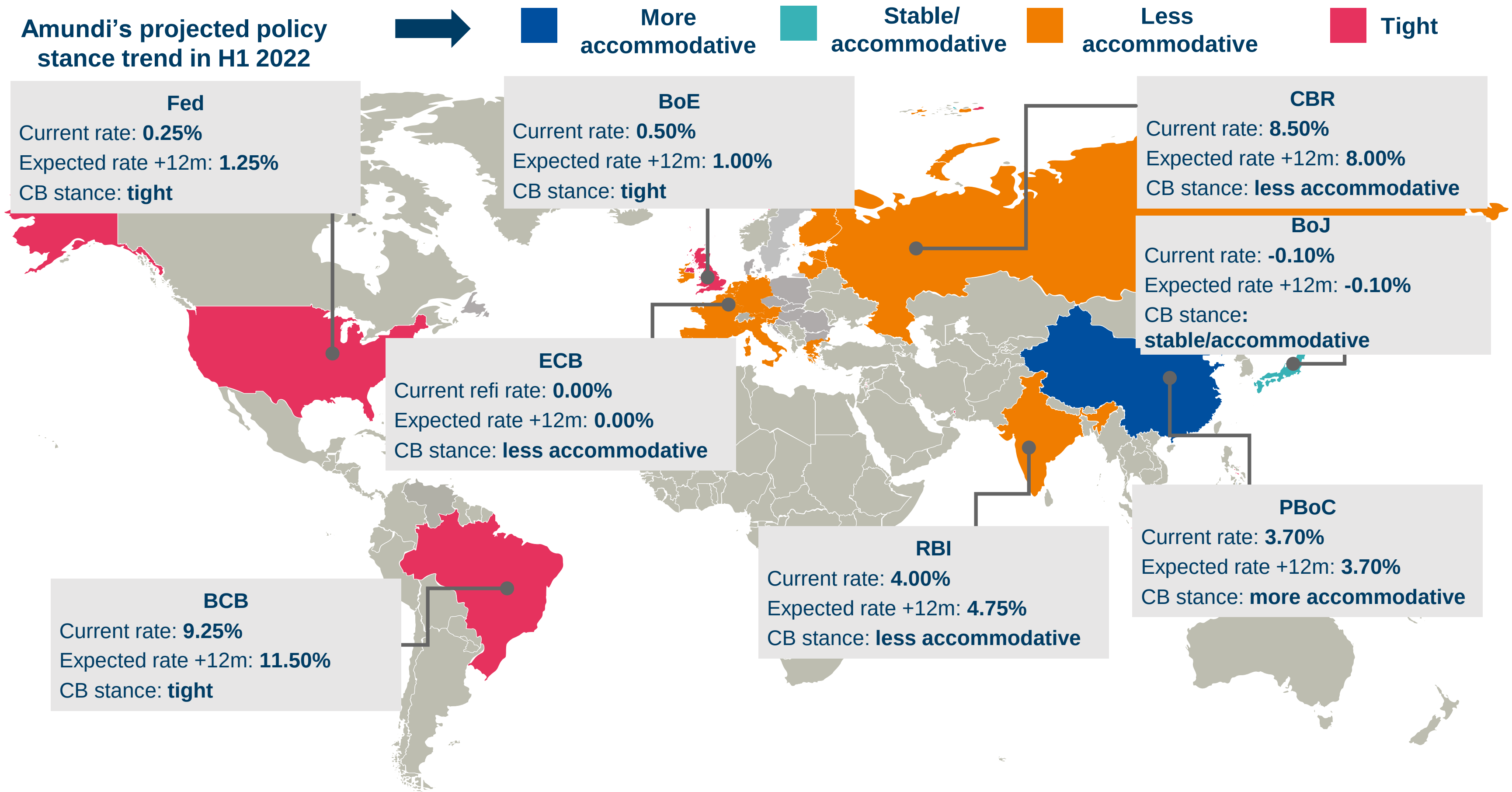
The natural gas production-demand gap is set to worsen in 2022 from already deeply negative levels in Asia – especially in China – and Europe. This imbalance is also due to geopolitical tensions, at least partly, which have been pushing oil prices well above 80 USD/barrel This, coupled with low US oil inventories, is likely to keep feeding inflationary trends.

Source: Amundi, Energy intelligence. Data is as of July 2021. bcm: billion cubic metres. Source: Amundi, EIA. Data is as of 14 January 2022.

02

A different central bank mindset: markets have started to react

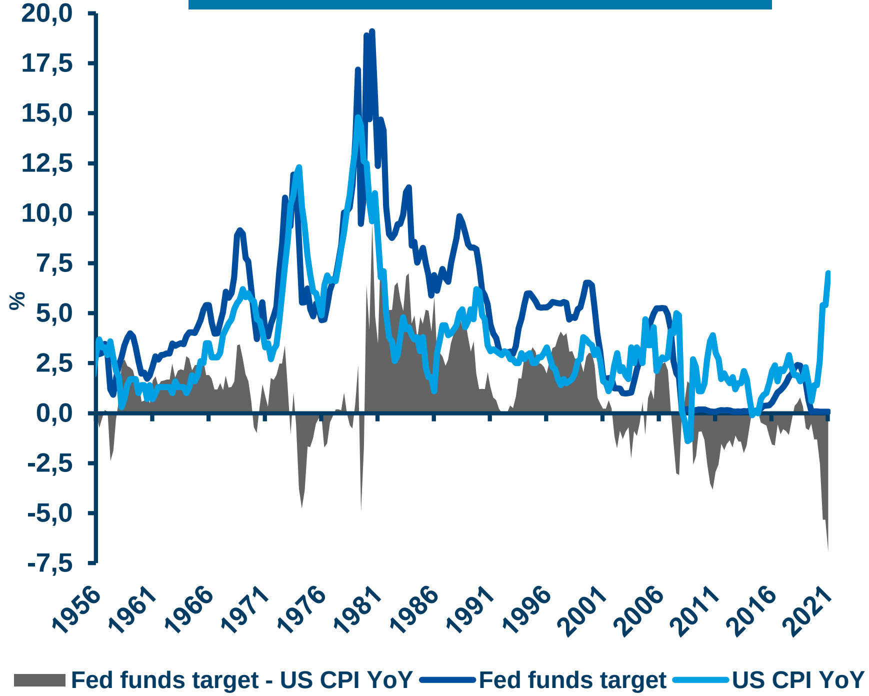
CB divergences in the fight against persistent inflation



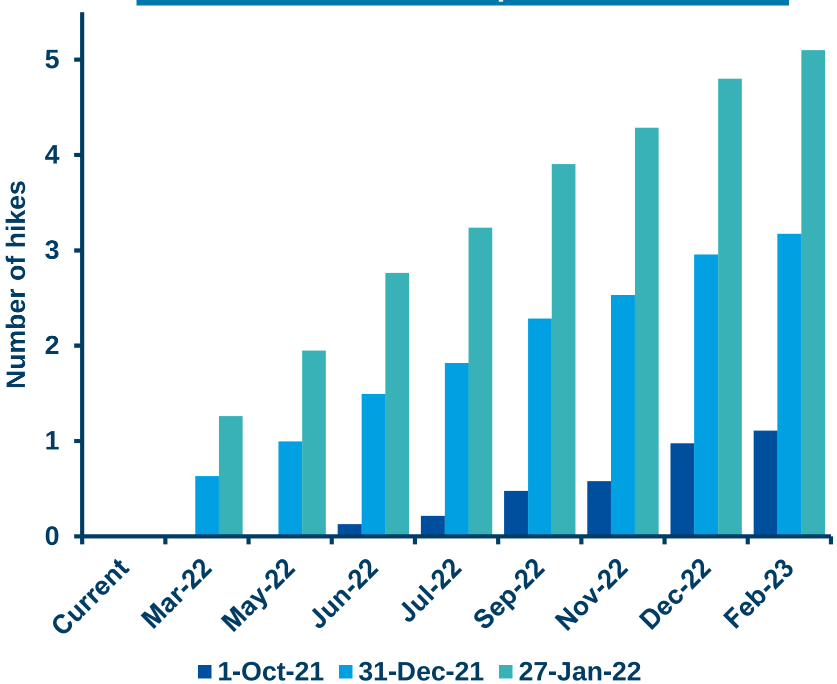
Source: Amundi Research as of 3 February 2022. Illustrative map for monetary policies. Central bank stance refers to expected changes on QE or unconventional tools positionthroughout mid-2022. DM: developed markets. CB. central banks. Fed: Federal Reserve; BoE: Bank of England; PBoC: People's Bank of China; BoJ: Bank of Japan; BCB: CentralBank of Brazil; CBR: Central Bank of Russia; ECB: European Central Bank; RBI: Reserve Bank of India.

Fed has never been so behind the curve, market expectation of Fed hikes are rising quickly

Fed behind the curve as never before



Fed funds futures now predict more hikes



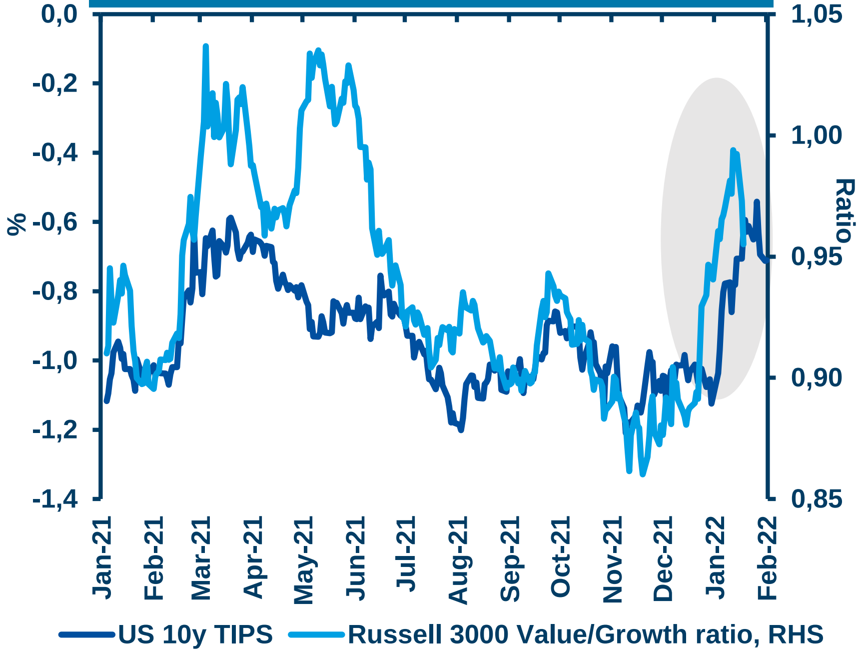
After having been in the 'transitionary inflation' camp for most 2021, the Fed acknowledged only recently that inflation may be higher and more persistent than initially thought. It will end its QE programme in March and should raise rates during the same month. Markets are now pricing in over five 25-bp rate hikes by February 2023.

Source: Amundi, Bloomberg. Data is as of 31 January 2022.

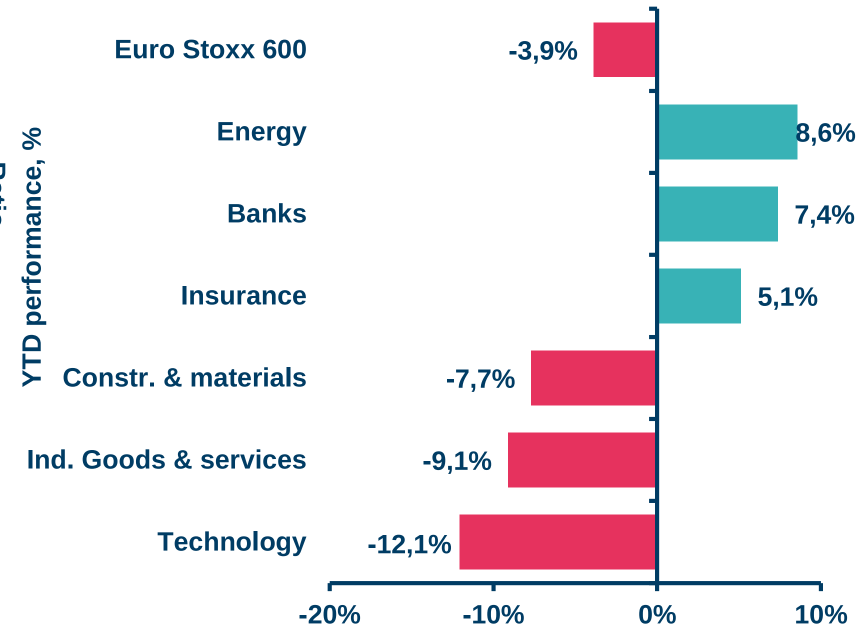
Source: Amundi, Bloomberg. Data is as of 27 January 2022.

Real yields are up and an abrupt rotation is occurring in equities

New year advances for real yields and value stocks



Sector rotation in Europe in 2022 Euro Stoxx 600 (top and bottom sectors)



US ten-year inflation-protected yields have been rising in early 2022. This move has come alongside an outperformance of US value stocks against growth ones. In Europe, the overall YTD performance has been negative, masking huge sector-level divergences, with value sectors outperforming growth ones.

Source: Amundi, Bloomberg. Data is as of 1 February 2022.

Source: Amundi, Bloomberg. Data is as of 1 February 2022. Performance data is in euro and refers to the top three and bottom three sectors within the Euro Stoxx 600index.

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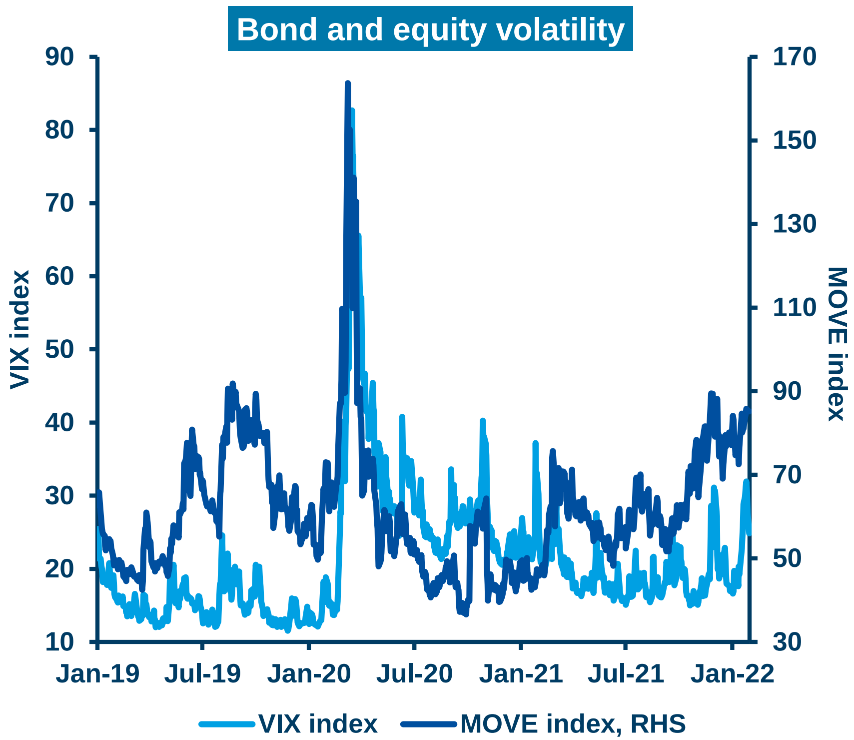
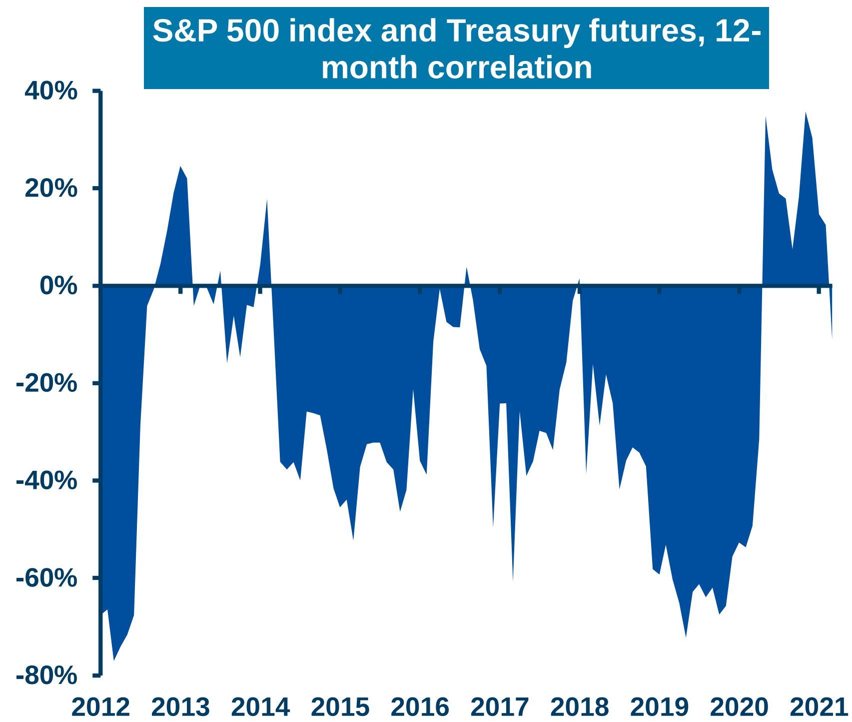
Volatility ahead and unstable bond-equity correlation





The volatility gauge of US Treasuries has been rising since September, as investors fear Fed rate hikes, unlike the VIX index, which measures swings in the S&P 500 index, and has started to rise only recently. However, equity swings may not be able to stay subdued for much longer. High volatility and rising inflation will make traditional cross-asset correlations more unstable.

Source: Amundi, Bloomberg. Data is as of 1 February 2022.

Source: Amundi, Bloomberg. Data is as of 1 February 2022. Data refers to the twelve-month correlation. CB: central banks.

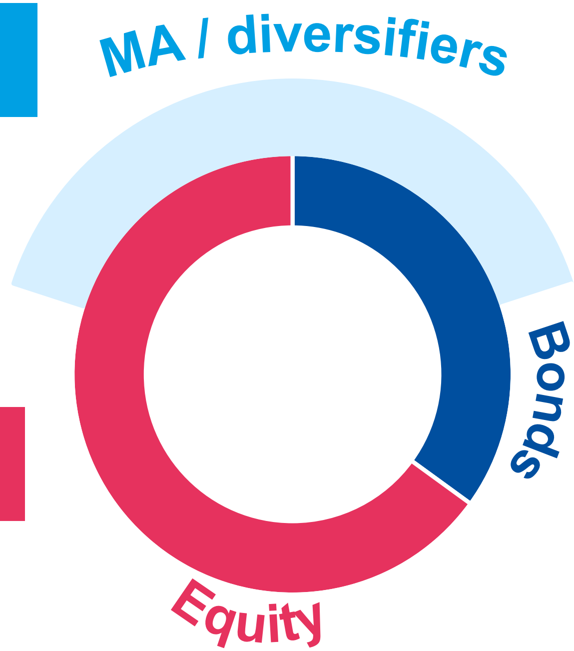
03

Strategies to protect portfolios from the inflation risk

Investors may rethink portfolios around the inflation theme

Real income assets and enhanced diversification

- MA real return solutions;
- Real assets;
- Liquid alternative strategies.



Multiple strategies, able to cope with higher rates

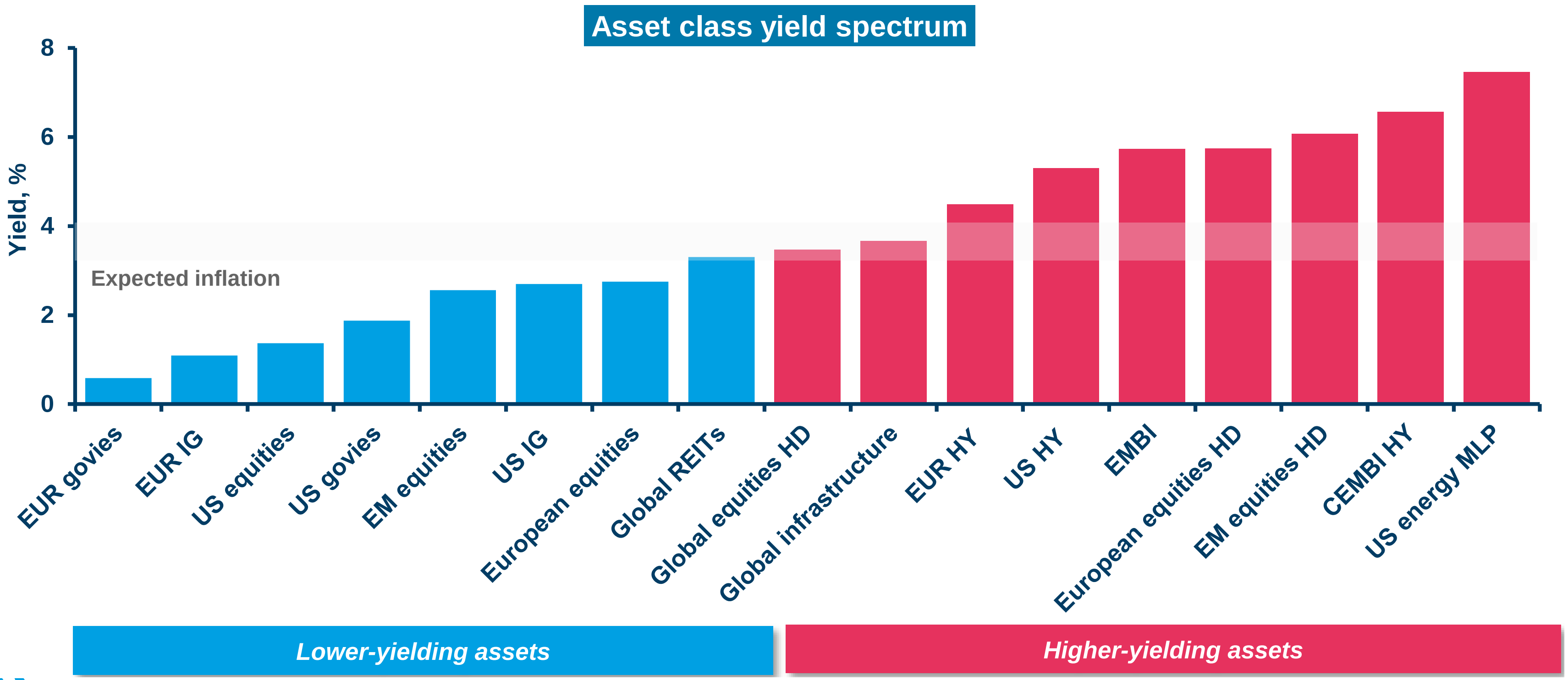
- Inflation-linked bonds;
- Floating-rate notes;
- Loans;
- Subordinated debt;
- EM short-term bonds.

Value, dividend and stock selection resilient to inflation

- EU, US, global value themes;
- Small caps;
- High dividend.

Source: Amundi as of 31 January 2022. EM. Emerging markets The portfolio is for illustrative use only..

Target real income through a wide range of assets

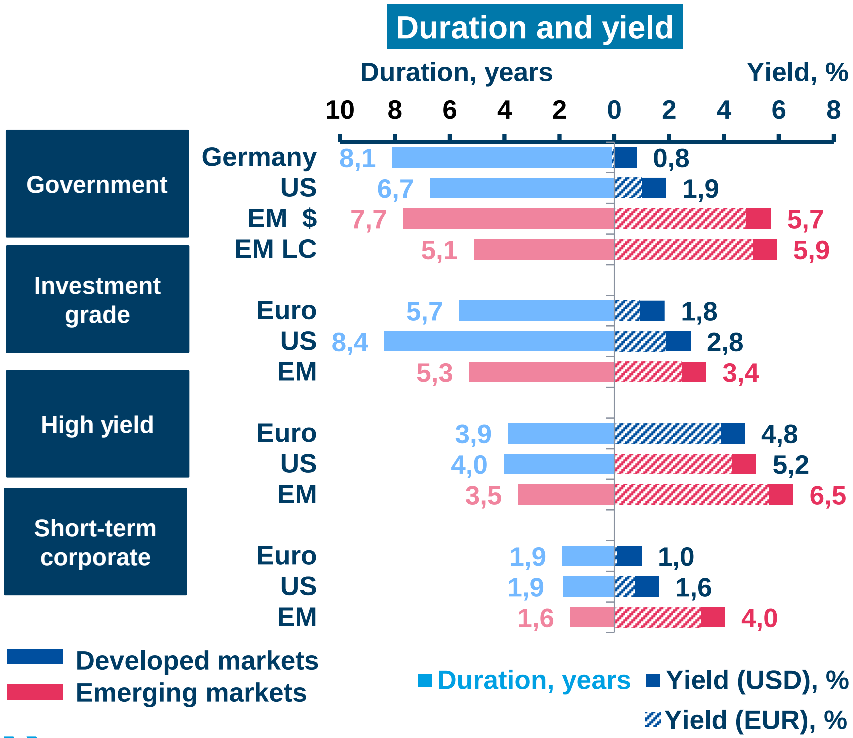


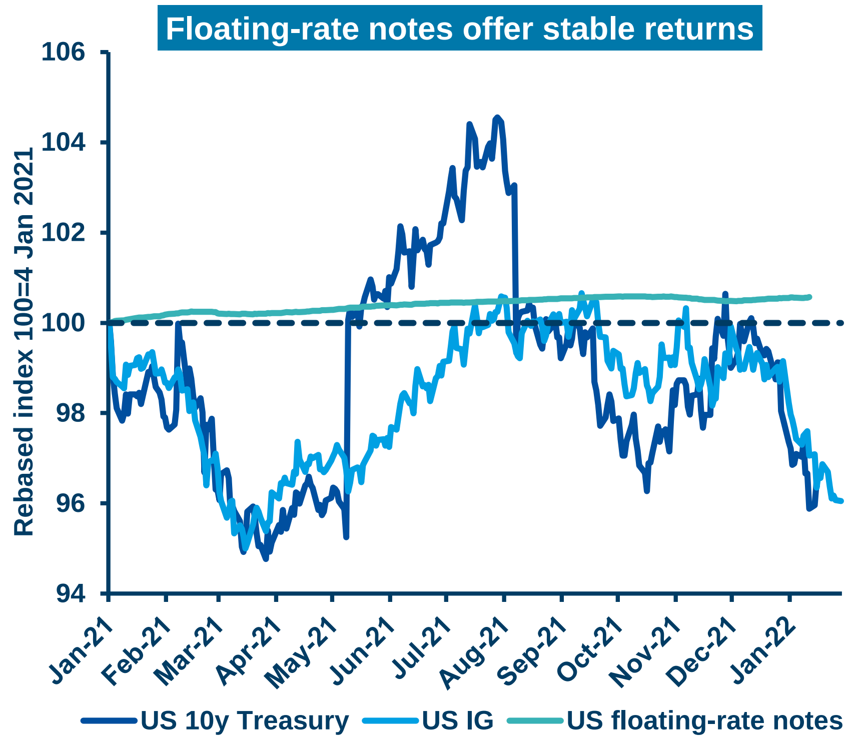
Higher-yielding asset classes can warrant above-inflation returns. Often, they can be found across alternative asset classes, so a broad-based investment approach – beyond the traditional benchmark approach – will be paramount.

Source: Amundi, Bloomberg. Data is as of 31 January 2022. Dividend yield refers to the past twelve months, yield for bonds indexes refers to yield to worst.

Limit duration exposure, remain flexible and focus on floating-rate strategies

Bonds





Investors should be flexible and include instruments such as securitised credit, floating-rate notes and inflation-linked bonds, alongside HY and EM debt with short duration and unlisted assets to propel their portfolio's income. Floating-rate notes typically have short maturities and high credit ratings, which could make them stable and appealing in the current context.

Source: Amundi analysis on Bloomberg data. Data is as of 28 January 2022.

Source: Amundi analysis on Bloomberg data as of 1 February 2022.

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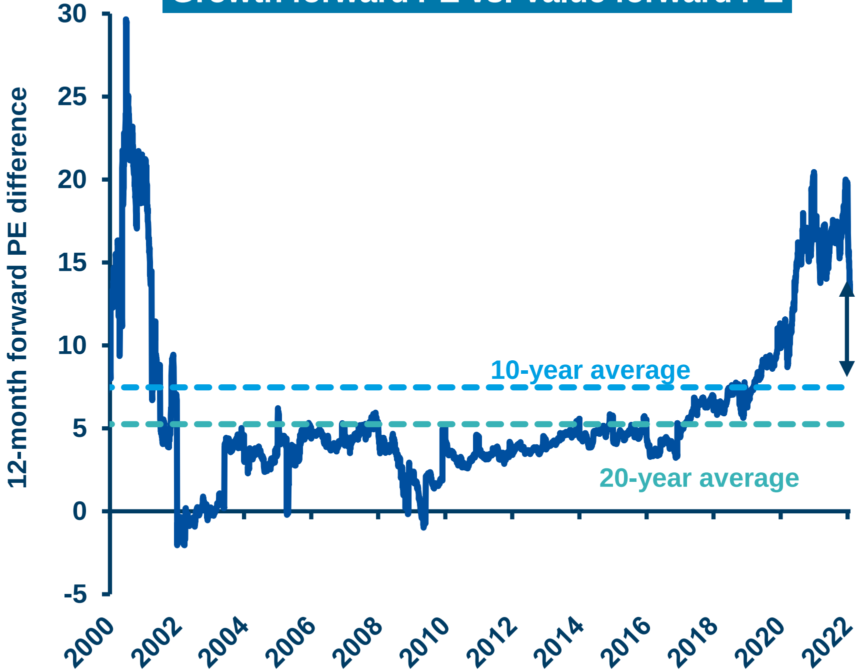
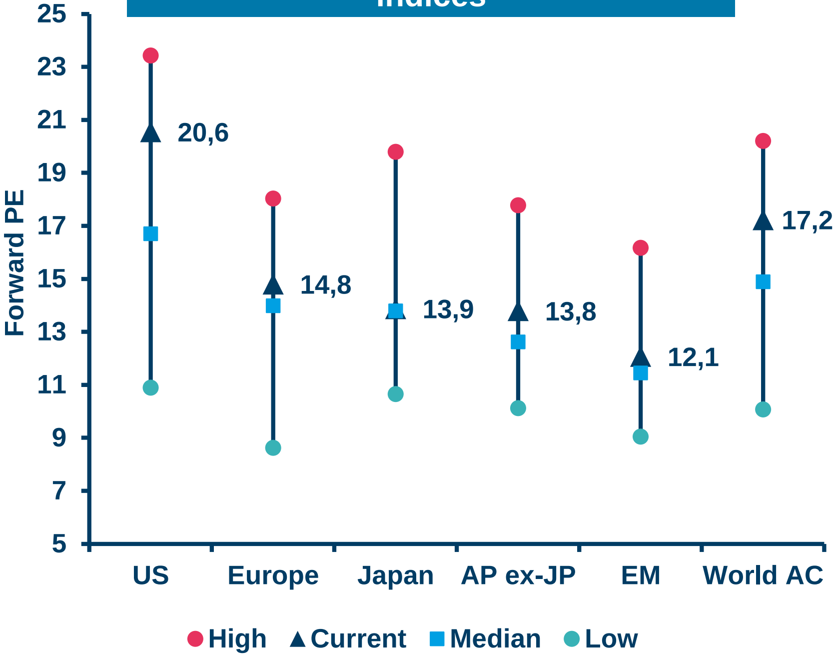
In equities, play value and markets with less stretched valuations

Growth forward PE vs. Value forward PE



12M Fwd. PE since 2009, MSCI indexes indices

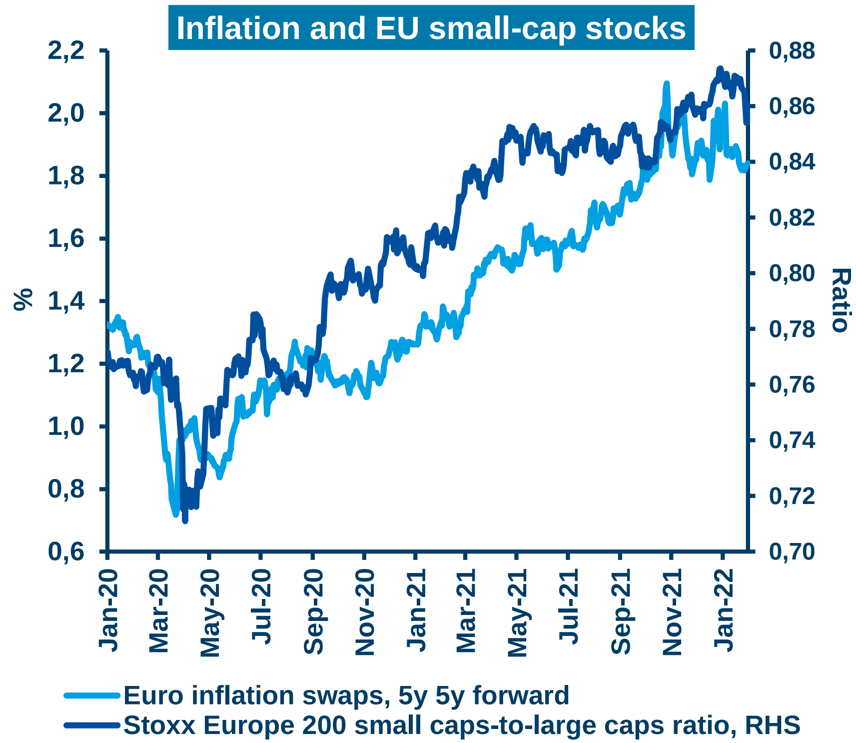


Value trades at a heavy discount to Growth. This, coupled with the expected rise in core yields, should be positive for some value compartments. We have already seen this year an over performance of value sectors, but we believe the rotation towards value is a multi-year trend. This path will not be linear, requiring investors to focus on fundamentals and quality of earnings growth. At global levels, we prefer markets such as Japan, Europe and selectively EM, for valuation reasons.

Source: Amundi, Bloomberg. Data is as of 31 January 2022. Data refers to best PE ratio. MSCI World Growth and MSCI World Value indices. PE: price-to-earnings ratio.

Source: Amundi Research, Datastream. Data is as of 28 January 2022.

In Europe, play dividends and small caps



In Europe, dividends can complement equity returns. At the same time, there appears to be some positive correlation between EU inflation trends and small caps performance. However, investors will need to be selective as earnings growth and liquidity could be affected in small caps.

Source: Amundi analysis on Bloomberg data as of 31 January 2022.

Source: Amundi analysis on Bloomberg data as of 1 February 2022.

"After having been on the backburner for decades, the great inflation comeback will mean that investors need to shift their mindsets from nominal to real returns. Playing ongoing market gyrations will be paramount for generating returns. Real yields will be the key driver: as long as real rates remain low, the market should hold ."

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17 Nov 21	2022 Investment Outlook - Investing in the great transformation
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Indices references and definitions

Yield and 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 Corp Short Term = J.P. Morgan CEMBI Broad Diversified 1-3 Year.

Definitions

- **Asset purchase programme:** a type of monetary policy wherein central banks purchase securities from the market to increase money supply and encourage lending and investment.
- **Basis points**: one basis point is a unit of measure equal to one one-hundredth of one percentage point (0.01%).
- **Breakeven inflation:** difference between the nominal yield on a fixed-rate investment and the real yield on an inflation-linked investment of similar maturity and credit quality.
- **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.
- **Cyclical vs. defensive sectors:** Cyclical companies are companies whose profit and stock prices are highly correlated with economic fluctuations. Defensive stocks are less correlated to economic cycles. Cyclicals sectors are consumer discretionary, financial, real estate, industrials, information technology, and materials, while defensive sectors are consumer staples, energy, healthcare, telecommunications services, and utilities.
- **Diversification:** Diversification is a strategy that mixes a variety of investments within a portfolio, in an attempt at limiting exposure to any single asset or risk.
- **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.
- **FX**: FX markets refer to the foreign exchange markets where participants are able to buy and sell currencies.
- **Quantitative easing (QE):** QE is a monetary policy instrument used by central banks to stimulate the economy by buying financial assets from commercial banks and other financial institutions.
- **Value style:** It refers to purchasing stocks at relatively low prices, as indicated by low price-to- earnings, price-to-book, and price-to-sales ratios, and high dividend yields. Sectors with dominance of value style: energy, financials, telecom, utilities, real estate.
- **Volatility**: 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.

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