MyStratWeekly
Market views and strategy

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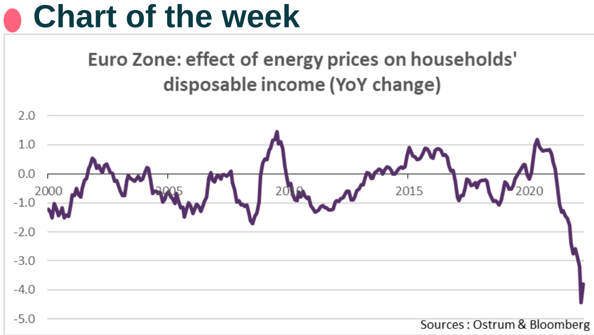
Topic of the week: Inflation, global phenomenon

- **Many commentaries explain that inflation dynamics are different from country to country. This view does not really stand up to analysis: a very large part of inflation is common to all OECD countries;**
- **For the investor, it is both necessary to have a global approach; more than a dozen countries have inflation-linked bonds. Country differences are sufficient to provide significant diversification opportunities;**
- **On the other hand, equities become particularly vulnerable to higher rates. And so the stock-rate diversification that we have experienced over the past two decades is probably dead.**

Market review: Equities dip ahead of Fed meeting

- **Fed: 50 bp hike and QT announcement this week;**
- **Higher yields lead to repricing of risk premia;**
- **US equities under pressure amid fund outflows;**
- **King dollar reigns as the only safe haven.**

Chart of the week



Rising energy prices are an important component of inflation growth in the euro area. It is also a negative contribution to household disposable income.

Using Eurostat figures, it can be seen that the change in energy prices has reduced household disposable income by about 4% over the last 12 months.

This is therefore a significant recessionary effect that should weigh on the trajectory of household consumption in the coming months.

Figure of the week

0 bp

Source : Ostrum AM

The spread between 30-year inflation swap rates in the US and in the euro area. The premium on 30-year US inflation average 45 pb since 2010

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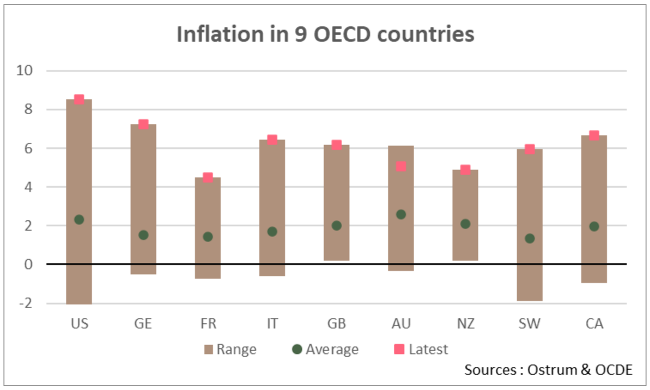
• Topic of the week

Inflation, global phenomenon

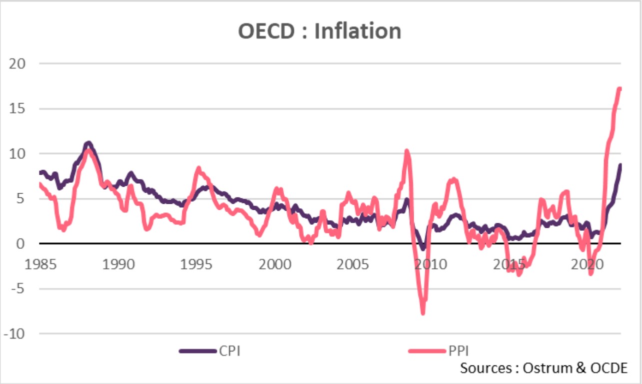
Many commentaries explain that inflation dynamics are different from country to country. This view does not really stand up to analysis: a very large part of inflation is common to all OECD countries. This is also true for market expectations. Current levels have a significant implication in terms of distortion of the risk premium.

All together

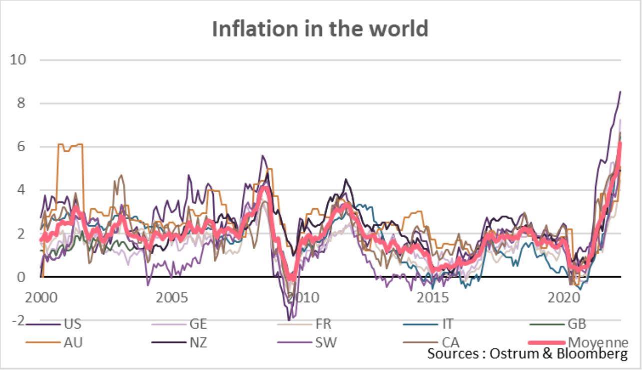
The graph below uses OECD harmonised data in order to have comparable inflation measures. It provides a picture of inflation in 9 OECD countries. All of these countries have inflation-linked bonds, which are therefore of direct interest to the investor. In all cases, with the exception of Australia, inflation is at an all-time high since 2000.



Coincidence? An important part of this inflation rebound is obviously linked to the very rapid rise in commodity prices, which are very widely globalized and therefore have a simultaneous impact on all countries. Still using OECD data, we find that the Industrial Price Index (IPP), very dependent on raw materials, explains almost half the changes in the Consumer Price Index (CPI).

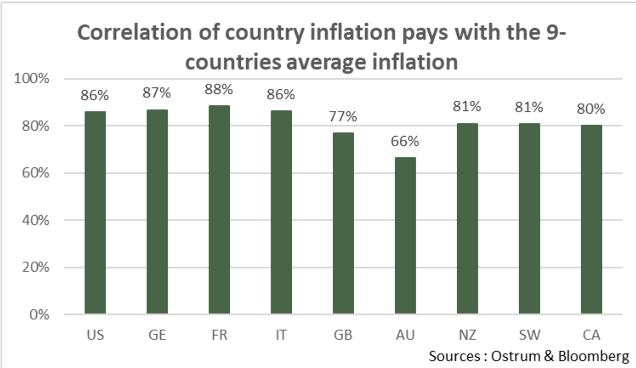


However, the current singular situation must not hide the fact that, in general, the movements of inflation, for the nine countries considered, have a strong tendency to be correlated. As the chart below shows. Inflation cycles appear to be very close for all countries.



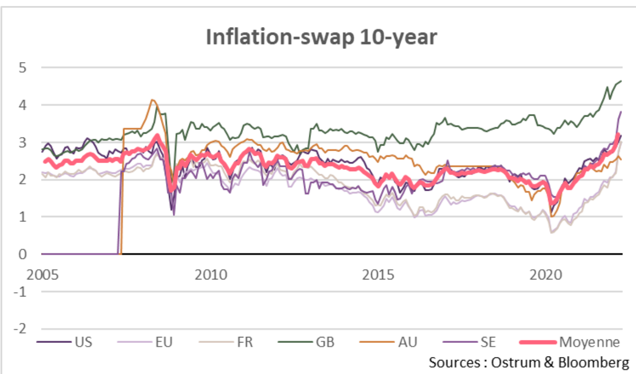
We have taken another step and calculated the correlation between the national indices over the period and the OECD average. These correlations can be seen as the part of a country's inflation influenced by the international common component. In all cases (again with the exception of Australia) the correlation is greater than 80%, implying that the 4/5 of the trajectory reflect common effects.

This result is important. On the one hand, because it shows that the alleged differences, for example between the United States and Europe, do not really hold. It is normal to find a close evolution in both cases. On the other hand, because the investor must therefore have a more general perspective and a global approach to the phenomenon.

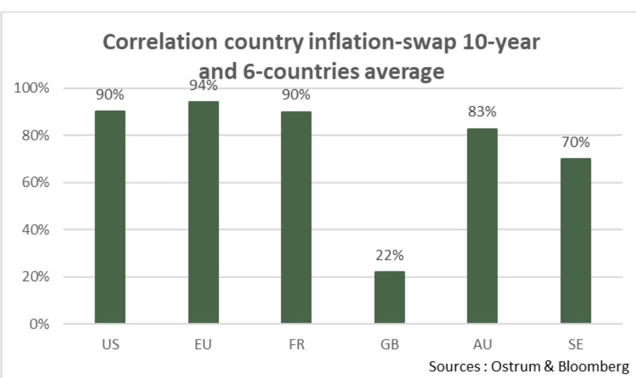


Similar for the market

Below, we focus on 6 countries that have a swap inflation market. This makes possible to compare equivalent financial products that have a constant maturity, in this case 10 years.



While common movements are also evident here, the result is less clear than in the above graph on inflation levels. And indeed, the correlations with the average of the 6 countries is lower. This is particularly the case in the United Kingdom, where the benchmark for inflation, the Retail Price Index (RPI) creates a decorrelation.

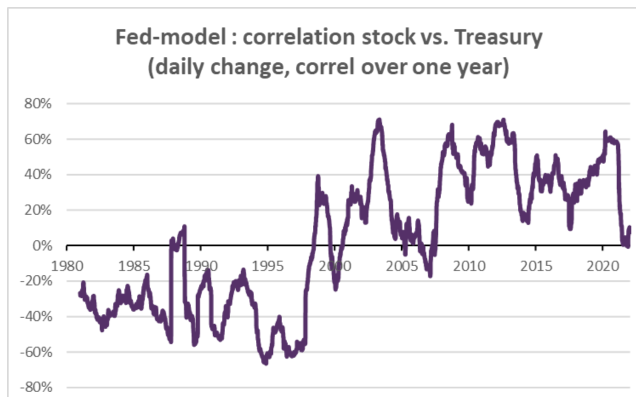


Equity markets don't like it

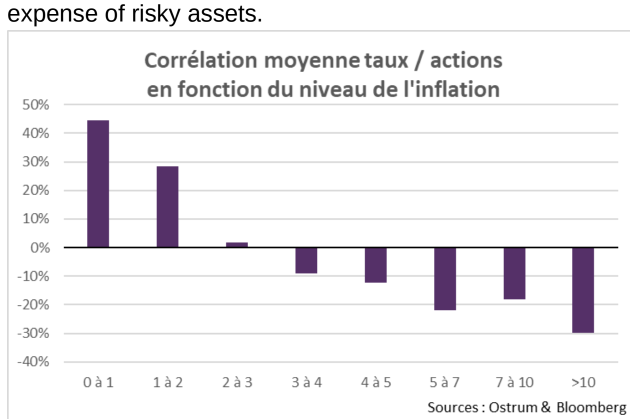
We are therefore seeing a stabilization of inflation expectations at a high level. This also has implications for the dynamics of equities.

The "Fed model" (which bears this name for mysterious reasons since the Fed has never validated it) is based on the idea that a rise in rates leads to a fall in equities. We can mention several mechanisms that explain this, in particular the fact that an increase in rates leads to a higher discount rate of future earnings, and therefore a lower valuation of equities. Implication is a negative correlation between rates and equities.

The graph below shows that this was the case until 2000, but has not been the case since then. A rather nice result, as equities and rates have therefore tended to move in the same direction over the past 20 years.

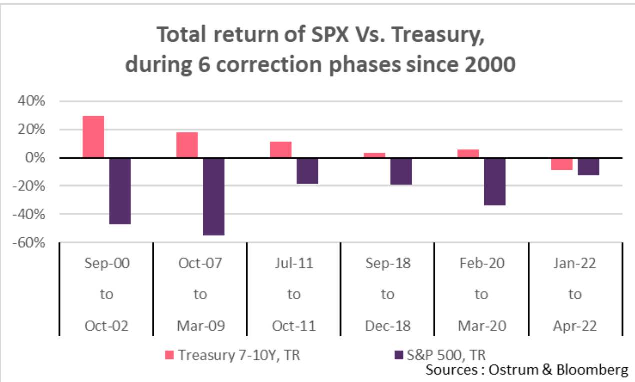


But why the change of regime in 2000? One reason that can be cited is inflation, as illustrated in the following graph. When inflation is low, rate hikes are not a problem for the stock market, whereas in periods of high inflation, the opposite is true. High inflation also means a central bank that reacts (as it does now) and the rise in rates is indeed assimilated to a tightening of financial conditions. At the expense of risky assets.



The result is an unprecedented situation since 2000 as shown in the graph below. There have been 6 major stock market corrections since that date, all of which were over 10%. Regarding the first five, the correction was accompanied by a significant drop in rates, and thus a standard Treasury portfolio provided attractive diversification for the investor.

That is no longer the case. Currently, the S&P 500 drawdown is 12.4%, a loss from the last high at the very beginning of the year. Over the same period, a Treasury portfolio lost 8.9%. No more diversification, but on the contrary a re-correlation.



Conclusion

Inflation is above all, and most of all, a global phenomenon. In this respect, the current rise in inflation offers a fairly large playing field for the investor. Since there are inflation-linked rate products in more than a dozen countries in the world. At the same time, about one fifth of each country's inflation is decoupled from the global trend, providing very relevant diversification opportunities for an investor.

On the other hand, this trend towards continued high inflation is bad news for equities. In particular, equities are becoming particularly vulnerable to higher yields. And so, the stock-rate diversification that we have experienced over the past two decades is probably obsolete.

Stéphane Déo

Market review

Equities dip ahead of Fed meeting

Inflation and growth data weigh on risky assets leaving the dollar as the only safe haven

Inflation and monetary tightening always act as a leaden cap on risky assets. The Fed and RBA are set to hike rates this week. The S&P closed April down 9% and the Nasdaq recorded its biggest monthly drop since the 2008 crash (-13%). The euro's plunge towards $1.05 is certainly cushioning the decline in equities on the continent. The credit markets are under pressure, as investors cut back risky positions as the London marketplace is closed on Monday. Protection buying pushed the iTraxx Crossover spread beyond 430 bps. Sovereign spreads are widening in the broad-based trend to rebuild risk premia. The 10-year swap spread rose above 80 bps. The dollar remains the only safe haven. The greenback is strengthening against all major currencies. The yen trades above 130 and the yuan weakens to 6.60 due to the astronomical economic cost of the Shanghai and Beijing lockdown measures.

Economic growth slowed in the first quarter. The US economy contracted by an annualized 1.4% in the first three months of the year. The deterioration in the external balance knocked 3.2 pp off GDP growth. The lesser inventory building subtracted 0.8 pp. Public spending, including in the defense sector (-8.5%), fell according to national accounts despite ongoing support for Ukraine. On the other hand, household consumption and private investment (equipment, R&D) show strong growth. The bumpy growth profile (+6.9% in 4Q 2021 then -1.4% in 1Q 2022) will probably be smoothed out with future revisions. Activity measured by the surveys or total hours worked seem rather compatible with stable growth of around 3-4%. In turn, Europe suffered from rising energy costs in the first quarter. The Italian economy contracts by 0.2%. On the other hand, Spain (+0.2%T) and Germany (+0.2%T) posted slightly positive growth. French GDP stagnated between January and March. The stabilization of the IFO and the high level of the PMI surveys are nonetheless encouraging. Inflation in the euro zone remains very high at 7.5% in April.

Bond markets remain very volatile. The dominance of inflation in the Fed's dual mandate justifies accelerating rate hikes so that the market trend remains for higher yields. A series of 50 bp hikes is now priced into the futures' market. A 75bp hike is not ruled out. In conjunction with rate hikes, the Fed will announce the start of its balance sheet reduction this week. The latest FOMC minutes suggested a monthly pace of $60bn in Treasuries and $35bn in MBS. The total QT envelope is still to be determined. In this context, the US 10-year note is approaching 3% with technical targets around 3.20%. Speculative accounts reduced their short positions despite the solid uptrend in bond yields. In the euro area, end-of-month duration extension purchases or the negative net bond issuance in April did not prevent German yields from continuing to rise. Inflation remains a determining factor for this trend. The weekly increase in inflation expectations was larger than the movement in nominal bond yields. The Bund nevertheless outperformed, as monetary tightening further impacted the valuations of risky debts. A rate hike seems possible as early as July and the weakness of the euro further reinforces this probability. The expected termination of the APP causes a rescaling of risk premiums. The 5- and 10-year swap spreads trade above the 80 bp threshold. The spread narrowing at the start of last month therefore proved short-lived. Similarly, the increase in French (52 bp) and Italian (186 bp) sovereign spreads shows the caution of market participants before the implementation of tighter policy. In Asia, the fall in the yen to its lowest level in 20 years is fueled by BoJ policy, which does not deviate from its 10-year JGB yield target. The Japanese 10-year remains capped at 0.25%. The yuan is suffering from capital outflows and lower growth due to the strict lockdowns of Shanghai and Beijing. The PBoC seems to let the CNY slide by refusing to raise interest rates.

Credit markets are not immune to risk aversion. Credit fund outflows continue. The month of April ended with spreads widening by 22bp on IG credit (151bp against Bund) and by 55bp on euro high yield. No high yield bond issuance for over six weeks now barely dampened the selling pressure. Subordinated financial debt or hybrid debts further underperformed. Market participants' caution is visible in significant tensions on credit indices' spreads. The iTraxx Crossover is trading above 430 bp.

The acceleration to the downside on equities is impressive, as ETF flows reversed in April in the United States after a period of uninterrupted net inflows since 2020. The Nasdaq plunged by more than 13% in April. The earnings season is hard to interpret. Upside surprises are the majority, but the earnings guidance points to a slowdown and greater difficulty in maintaining margins. In Europe, the decline is more limited to around 4% in the euro zone. The UK market is stable. Rising rates do not benefit banks and obviously hit technology. However, quality is not the safe haven hoped for in this environment of uncertainty. The outperformance of high-dividend stocks in April, just before the dividend payout period, echoes the reduction in duration seen in bond portfolio management.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	02-May-22	1wk (bp)	1m (bp)	2022 (bp)
EUR Bunds 2y	0.24%	+10	+31	+86
EUR Bunds 10y	0.97%	+13	+41	+114
EUR Bunds 2s10s	71.9bp	+3	+10	+29
USD Treasuries 2y	2.73%	+10	+27	+199
USD Treasuries 10y	2.99%	+17	+60	+148
USD Treasuries 2s10s	25.9bp	+7	+34	-51
GBP Gilt 10y	1.91%	-6	+26	+93
JPY JGB 10y	0.23%	-2	+5	+6
€ Sovereign Spreads (10y)	**02-May-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
France	52.55bp	+5	+0	+15
Italy	189.54bp	+16	+6	+54
Spain	104.82bp	+6	+1	+30
Inflation Break-evens (10y)	**02-May-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR 10y Inflation Swap	3.08%	+13	+26	+98
USD 10y Inflation Swap	3.11%	-2	+11	+34
GBP 10y Inflation Swap	4.68%	+5	+11	+50
EUR Credit Indices	**02-May-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
EUR Corporate Credit OAS	151bp	+13	+21	+56
EUR Agencies OAS	64bp	+4	+5	+15
EUR Securitized - Covered OAS	77bp	+5	+11	+31
EUR Pan-European High Yield OAS	450bp	+46	+52	+132
EUR/USD CDS Indices 5y	**02-May-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
iTraxx IG	90bp	+7	+19	+42
iTraxx Crossover	429bp	+33	+95	+187
CDX IG	84bp	+5	+19	+35
CDX High Yield	464bp	+29	+98	+171
Emerging Markets	**02-May-22**	**1wk (bp)**	**1m (bp)**	**2022 (bp)**
JPM EMBI Global Div. Spread	439bp	+20	-1	+71
Currencies	**02-May-22**	**1wk (%)**	**1m (%)**	**2022 (%)**
EUR/USD	$1.052	-1.820	-4.138	-7.5
GBP/USD	$1.252	-1.727	-4.536	-7.5
USD/JPY	JPY 130	-1.575	-5.684	-11.6
Commodity Futures	**02-May-22**	**-1wk ($)**	**-1m ($)**	**2022 (%)**
Crude Brent	$106.9	$4.7	$4.1	40.92
Gold	$1 871.6	-$26.3	-$61.2	2.32
Equity Market Indices	**02-May-22**	**-1wk (%)**	**-1m (%)**	**2022 (%)**
S&P 500	4 115	-4.21	-9.47	-13.7
EuroStoxx 50	3 732	-0.67	-4.75	-13.2
CAC 40	6 426	-0.37	-3.87	-10.2
Nikkei 225	26 819	-1.06	-3.06	-6.9
Shanghai Composite	3 047	-1.29	-7.18	-16.3
VIX - Implied Volatility Index	34.95	29.35	78.04	103.0

Source: Bloomberg, Ostrum AM

Additional notes

Ostrum Asset Management

Natixis Investment Managers

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