

# INFLATION RISKS: WHAT IMPACT FOR INVESTORS?



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## TOWARDS HIGHER AND MORE SUSTAINABLE INFLATION ?

The central scenario is a return of GDP to pre crisis levels by the end of next year. Growth would then revert to its long-term trend. Inflation, after a period of overheating, would return to lower levels, and would stabilise between 1.0% and 1.5%.

The alternative scenario is a more significant and, above all, more sustained increase in inflation. There are multiple reasons for this scenario:   
 - a global rise in inflation (the United States, Eastern Europe, etc.),   
 - shortages in certain sectors and disruption of production chains that are not rapidly solved,   
 - wage inflation linked to a rapid recovery and a sectoral reallocation that is creating tensions in the labour market,   
 - changes in central banks' attitude that tolerate more inflation,   
 - increases in public spending and deficits due to an ageing population,   
 - strong growth in monetary aggregates which has effects on prices influenced by financial variables.

One can then imagine a scenario in which inflation stabilises within a 2-3% range in a more sustainable way. In this case, the ECB will be forced to reduce its support for activity and its very lax monetary policy more quickly than expected.

A variation of 225 bps over 4 years, as we expect, has not arrived for a quarter century. Such increases, however, was common during the 60's to 90's, when rates were higher. This would be a sharp break from the trend of the last quarter century, but the level reached would not be aberrant.

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## "SATELLITE" BONDS LESS PENALISED

Sensitivities to changes in Bund and inflation were estimated for 3 major asset classes - interest rates, equities, commodities - over the 1998-2021 period.

We observe that they are variable according to the asset class and market regime.

While core bonds - government, corporate IG - have a negative inflation sensitivity whatever the market regime, commodities provide a good inflation hedge in most market environments.

The inflation sensitivity of equities varies according to market direction: it is rather positive during declines and negative during phases of rises for Value and High Dividend stocks as well as Basic Materials, Industrials, Financials and Utilities. The opposite is true for Growth and Momentum stocks and Healthcare sectors.

In the event of a sharp and sustainable rise in inflation coupled with a rise in rates (alternative scenario), asset classes with negative Bund and inflation sensitivities would be penalised, in particular core fixed income assets that would go into zero or negative performance areas. This is not the case for "satellite" bonds (high yield, emerging debt...) which would maintain a positive expected performance. This scenario would also benefit equities and some commodities (copper).

## HOW TO SELECT THE RIGHT ASSETS

Ostrum AM's 5-year allocation views favour equities over fixed income, both for insurance-based and traditional active investment, as a natural hedge to our central and alternative scenarios, with an attractive expected dividend. Diversification into funds will have to be even more selective!

Market timing of fixed income selection will be crucial to take advantage of expected volatility and benefit from attractive entry points. For credit, banks will be favoured. Indexed bonds will be avoided for active insurance management.

For equities, the value style and cyclical stocks will benefit from an environment of rising inflation. But we must be cautious of value traps. Growth style and defensive stocks will struggle to perform. Moreover, sectoral allocation will remain discriminating for equity management.

In terms of diversification via funds, variable rates and convertible bonds look the most attractive to us. Euro-hedged emerging market debt offers significant carry but geographical selection and active duration management will be crucial, especially over the short term. The same is true for shorter-duration high yield bonds, with default risk under control. Inflation carry and breakeven strategies should be favoured amongst inflation-linked assets. Global bond diversification will focus on total or absolute return strategies with tactical and active duration management.

## ADDITIONAL NOTES

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