MyStratWeekly
Market views and strategy

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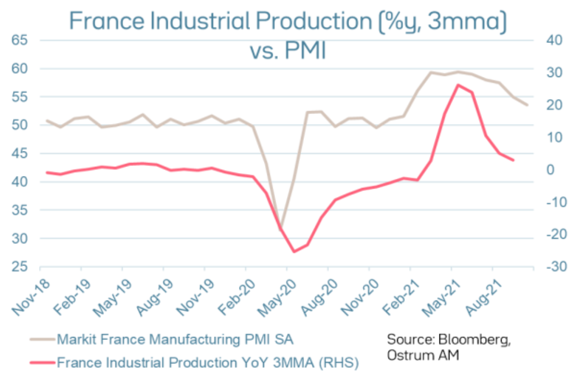
Topic of the week: Why this level of inflation is a concern

- **The debate on whether inflation is temporary or not misses the point. The impact is already being felt widely in the markets;**
- **First on the curve, with the debate on the normalization of monetary policy. Its acceleration creates considerable volatility;**
- **On the equity side, the current level of inflation is more than enough to distort the relative level of sectoral margins and generate significant market turnover;**
- **The current calm in equity markets is in stark contrast to the stress on rates. This dichotomy is not sustainable.**

Market review: Unreliable BoE

- **BoE: incomprehensible status quo;**
- **Gilt yields fall back below 1%, T-note at 1.45% despite strong jobs;**
- **Equities at the top with the S&P close to 4,700 points;**
- **Sovereign spreads erase late-October stress.**

Chart of the week



Industrial production in France (and other countries including Germany) came out well below consensus expectations over the summer.

Surveys (PMI and others), however, indicate growth that is still strong, although it has been slowing down since the spring. Supply bottlenecks, recruitment difficulties and the energy crisis are major obstacles to activity growth. The gap between economic publications and business surveys is worth watching.

Figure of the week

22%

The level of High Yield in China. An all time high. The effects of Evergrande lead to some worries about credit availability.

Source : Ostrum AM

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Topic of the week

Why this level of inflation is a concern

The inflation debate tends to crystallize over the duration of the shock we are experiencing. To speak of transitional inflation is to forget that current levels, certainly reasonable in comparison with the 1970s or 1980s, are definitely sufficient to create strong market distortions. The yield curve moved considerably in October with expectations on central banks' rate changing sharply. However, the increase in industrial prices also have a major distorting effect on profit margins, with a very wide variety of sectoral responses. Similarly, wage growth, which for the time being remains relatively sound, can create the same effects. For markets this can lead to large sectoral rotations.

The battle is raging between proponents of a "temporary" inflation thesis and those who believe inflation is more persistent. It's all temporary. The last inflation surge in the late 1970s was temporary, only for two decades. The dinosaurs were temporary too, they only stayed on earth 180 million years.

The problem is elsewhere.

For sure inflation will eventually fall. But the "temporary" aspect lasts and the level of inflation is largely sufficient at the moment to create significant distortions on both economic and financial variables.

The "benign neglect" of the current figures seems far from adequate.

Here we will look at the consequences for financial markets.

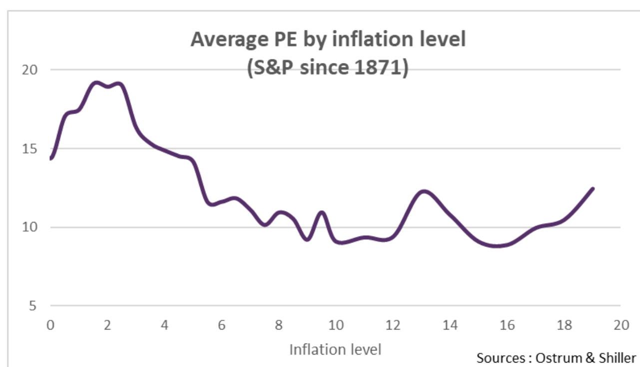
Why a 2% inflation target?

The ECB's Governing Council has decided to set the inflation target at 2 % over the medium term. Many central banks, starting with the Fed, have identical or similar objectives. Why 2%? The stability should simply be 0%.

There are several reasons for this. For example, a 0% target implies that some prices must fall to compensate for the rise in others. So, it implies deflation in certain sectors. In the case of the Euro Area it may also be noted that 0% inflation in the area implies that some countries must be in deflation, again to compensate for other inflation.

Another argument is that the risks are asymmetrical, an argument abundantly used for example by Mario Draghi in his time. The idea is that an inflation overshoot can be dealt with by a monetary tightening. Conversely, deflation is very difficult to counteract. It is therefore better to aim a little too high (2% instead of 0%) to avoid being too low.

Finally, there is a practical argument. Moderate price increases allow for adjustments and thus facilitate growth. Moreover, the chart below shows that the equity markets validate, roughly speaking, this view. Taking the valuations of the American markets (which allow us to go back more than a century and a half), we see that the optimum of inflation is indeed in an area close to 2-3%. The argument is also valid in economics, academic literature converges on the idea that moderate inflation, again in the order of 2-3%, is an optimum.



A schizophrenic curve

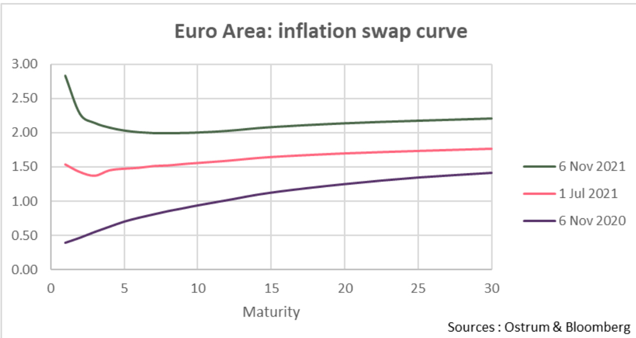
The first consequence, of course, is interest rates. It seems that the market outlook on inflation has changed quite sharply since this summer, certainly continuing the trend from the past year.

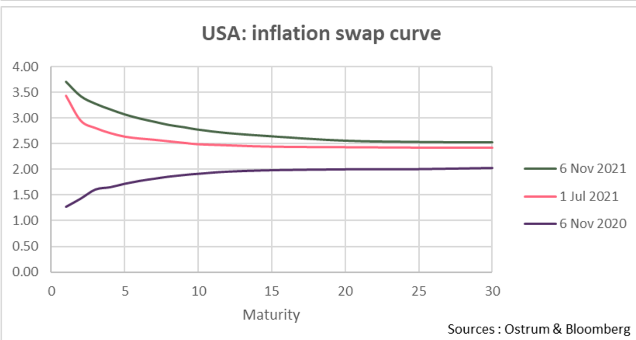
As a result, inflation expectations are finally quite similar in the United States and Europe:

- inflation well above 2% in the immediate future (2.3-4% in Europe, almost 4% in the US);

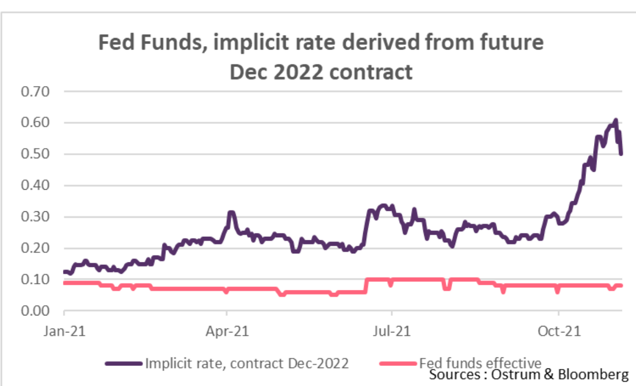
- a rapid decline thereafter, so inflation is seen as transitory by the markets;
- and then figures that stabilize nicely on a level close to 2% (rather 2.5% in the case of the United States), the objective of the two central banks.

In short, after the current, purely temporary inflationary shock, everything would go back to normal.

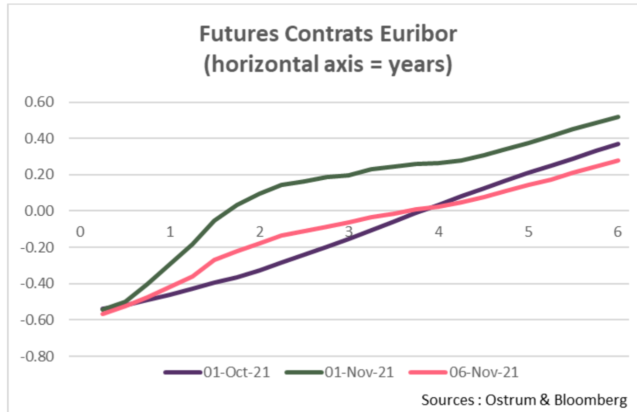




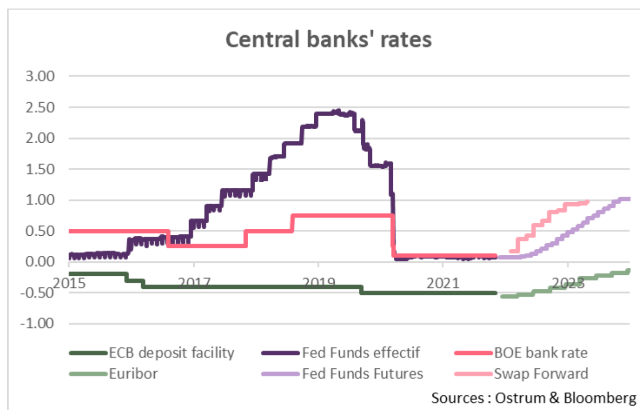
These movements, however, were sufficient to change sharply the expectations on central banks' interest rates. Let's start with the Fed. Prior to the September 22 FOMC, the curve was consistent with a slightly greater than 50% probability of a rate increase in 2022. Prior to last Wednesday's FOMC, the curve was expecting two increases for sure and was beginning to speculate on a third. An impressive change in such a short time, even though these expectations have been somewhat reduced since the last FOMC.



The same pattern can be seen when it comes to the ECB, of course less exacerbated. The fact remains that the movement on Euribor contracts was also quite impressive during the month of October. Futures were expecting the Euribor to move above zero by the end of 2023, which seemed quite optimistic to say the least. Since then, expectations have quickly calmed down (as in the US) and the curve now tells us that finally rates won't get positive before late 2024.



Despite these very strong curve movements, there remains a strange part. The markets are expecting rates to rise, particularly from the Fed, but also from the BoE, quite fast. Two rate hikes in 2022, perhaps three in the case of the Fed, while QE will not end until the middle of next year, this is going a bit fast. On the other hand, the Fed would only raise its rates slightly. For example, the 1-year Treasury rates in 3 years are close to 1.5%. We are therefore much lower than the 2.5% reached on the Fed funds during the last round of rate hikes.



The story that the curve tells thus seems schizophrenic: rate increases both relatively aggressive, because very fast, and at the same time limited since the Fed would stop very quickly. All this seems a bit inconsistent, especially with, as we said earlier, inflation stabilizing exactly where it needs to be. Kind of a Goldilocks world in which just a few moves from the Fed puts back inflation exactly where needed.

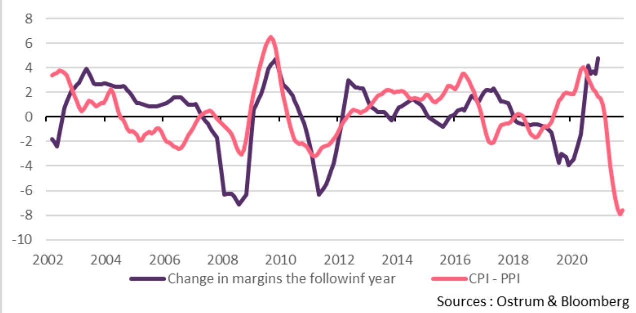
In sum, current inflation figures have been largely sufficient to move the curve very significantly. Its current position seems consistent with an unlikely scenario of short but violent rate increases. So there is a reason for the curve to move again.

Risk on margins

Inflation is now higher than this 2% mark. Is this a problem for corporates? The figures are far from what was seen in the 1970s or 1980s.

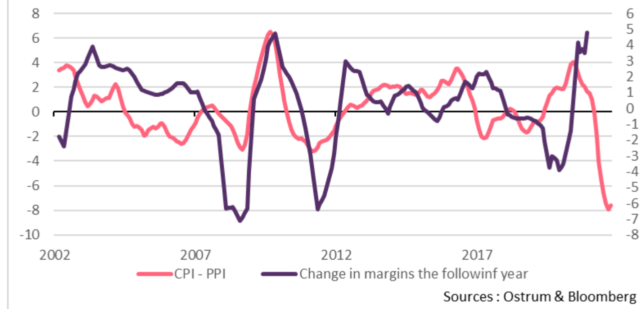
CPI inflation (consumer price index) is a proxy of the increase in sales prices of corporates, the PPI (producer price index) is a proxy of the cost of production for these same corporates. The difference between the two must therefore tell a story about the dynamics of margins. And indeed, the difference between the two is, as next graph shows, well correlated with the evolution of margins over the following quarters.

The message is rather disturbing. With PPIs in Europe exceeding 10%, business costs are rising rapidly and price increases are only partially offsetting that. As a result, the "CPI-PPI" approach suggests that margins variation may be relatively negative over the coming months.



Euro Stoxx : price and margins dynamic

Same chart, but for the S&P 500 this time. And we find the same relatively stable relationship between price developments and margin distortion over the following quarters. The same conclusion: the next twelve months should show a compression of the margins.



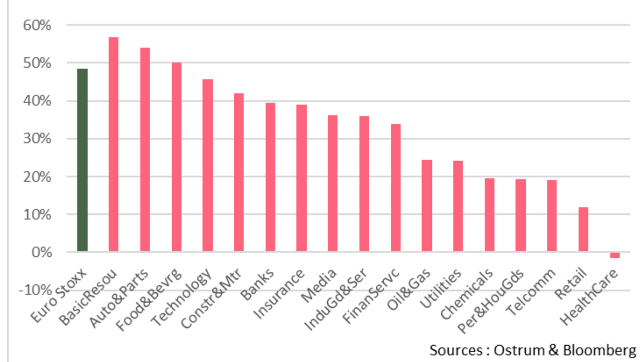
S&P 500 : price and margins dynamic

In conclusion, the current price developments, even if they prove to be temporary, are largely sufficient to have a significant impact on company margins. What is changing this time is that the valuations of the shares are very tense and a decrease in profitability could then be more violently sanctioned by the markets.

Sectoral distortion

Of course, not all sectors are equal before this problem. Some sectors will benefit from rising industrial prices, while others have enough pricing power to offset their rising costs.

Not surprisingly, the reaction of the sectors to this effect is indeed very disparate. The three sectors that react the most, basic resources, automotive and food, are indeed sectors where pricing power is relatively low, but also sectors where raw materials constitute an important part of the cost base. Sectors that are therefore much more sensitive to a CPI/PPI divergence.



Euro Stoxx : correlation CPI-PPI v. sectors

The Food&Bev sector is a good example of this process. The current margins are close to 11%, granted that our approach is correct, they could lose more than two points in a year and a half. A potentially significant loss.

Materials are an important part of the cost structure: glass, aluminum, energy and of course some agricultural raw materials. The increase in industrial prices therefore has a significant impact on the players in this sector. In terms of pricing power on the other hand, the situation is much more heterogeneous, brewers for example are the worst off while it will be much easier for luxury brands to defend their margins (less proportion of raw materials in the cost structure, more pricing power). Our sectoral approach must therefore be even more refined.

On the other hand, some sectors are hardly affected by these price movements: the health sector for example, but also retail.

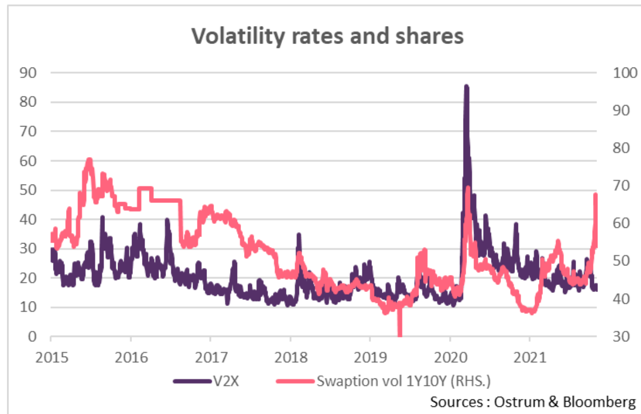
Thus, beyond the aggregate risk to the index of price change, the main subject seems to be the potential sectoral rotation. The divergence of reactions can indeed lead to a very marked dispersion of performance.

Conclusion

The debate on the sustainability of inflation is somewhat off topic. The impact of rising prices is already being felt. On the curve obviously with the debate on the normalization of monetary policy. After a lot of volatility on the curve, the currently priced scenario is certainly plausible but difficult to envisage and even to some extent contradictory. If the stress on the FI markets is already high, we must therefore prepare for much more volatility in the future.

On the equity side, the current level of changes in inflation is more than enough to distort the relative level of sectoral margins and create significant market rotation. For the moment the stock market has not really taken this dimension into account. The reporting season is very positive and supports the ongoing euphoria. Once the information on the last quarter is digested, the projections for the end of the year and the beginning of next year may be a more bitter pill to swallow.

Perhaps a single graph summarizes this view. The implied volatility on the fixed income market is at very high levels, the volatility on equities remains very low. We see the same widening gap in the United States. This type of divergence is unusual, and it has never been long-lasting. Historically, it is volatility on rates that ends up contaminating volatility on equities.



Stéphane Déo

Market review

Unreliable BoE

BoE communication says a lot about the reality of inflation mandates

Central banks play with financial markets. The BoE's status quo on rates (0.1%) caught investors by surprise, as many were anticipating a hike in keeping with the recent communication from central bankers. A 7-2 vote in favor of the status quo seemed unimaginable. The reliability of the BoE's communication has often been mocked. Andrew Bailey's will be no exception. After the fact, the BoE governor half-jokingly suggested that market expectations, albeit in the right direction, were excessive.

The unexpected decision prompted the unwinding of many short rate positions that had been implemented against the backdrop of a tighter global monetary environment. The RBA lifted its guidance of zero rate until 2024 in the wake of earlier tightening from the Reserve Bank of New Zealand. The BoC also prematurely ended quantitative easing. In emerging markets, the unexpected magnitude of the rate hike in Poland (+75bp) and communications from the Russian and Brazilian banks leave little doubt about the global dimension of inflationary pressures.

The other surprise of the week is the inanity of Jerome Powell's speech. His reappointment as head of the Washington institution appears to be compromised by the scandal of personal financial transactions made by several FOMC members. As a result, his word now carries much less weight. Lael Brainard, expected to be the next Fed Chairperson, has not communicated her view recently. According to the FOMC statement, the wind-down of asset purchases will run until June 2022 at a pace of $ 15 billion each month. The Fed Funds hike is not expected until the second half of the year after a transition period. Euro-dollar contracts nevertheless price in an increase as early as July. The Board of Governors is struggling to justify the monetary status quo as inflation runs above 5%. The fiscal situation and the issue of the debt ceiling need to be clarified before December 3. The second "social" infrastructure plan will be cut to some $ 1,700 billion, with Senators Manchin and Sinema opposing climate investments and the tax increases needed to fund them. In addition, Biden's power of influence is waning after two setbacks in the gubernatorial elections in New Jersey and Virginia. Even OPEC no longer bows to US pressure. The oil cartel won’t raise oil production beyond the agreed 400k bpd hike in December as demanded by the US Administration.

On the economic front, surveys remain robust. The ISM for services is at historical highs. The economy added 531k jobs in October despite 73k public layoffs. Unemployment is down to 4.6%. The unchanged participation rate however is a sign of a permanent loss of labor supply, which effectively brings the economy closer to full employment. In Europe, bottlenecks are causing industrial production to contract despite upbeat surveys.

Market dynamics are somewhat paradoxical. The Fed's accommodative stance is a burden as inflation accelerates. Excessive tightening would undoubtedly quickly reveal the underlying financial weaknesses. In other words, reaching a macro-financial equilibrium seems to require structurally negative real rates over prolonged period of time. The market recognizes it and the reluctance of central banks to act preemptively will always justify a long bias on risky assets. The low rates and the flattening of the yield curves are also amplified by the cautious language used by policymakers, which is akin to a form of micro-management of markets by putting a ceiling on risk and term premiums. The T-note thus closed last week under 1.50% with 30-year yields under 1.90%. The US Treasury's refunding strategy is also limiting pressure on long rates. The amounts to be auctioned have been capped in particular on the 20-year maturity. The US Treasury will remain opportunistic as regards TIPS auctions.

In the euro zone, the yield on Bunds fell back to -0.27%, in the wake of T-notes and Gilts. Sovereign spreads have been volatile since the end of October. The Portuguese coalition has not reached a budget agreement for 2022 and early elections will take place at the end of January. Italy announced fiscal stimulus to the tune of € 23 billion (1.2pp of GDP) including tax cuts, social spending and public investment. The fiscal situation in France has deteriorated compared to 2020 and transfer payments to households motivated by the energy crisis seem to be setting the tone for the upcoming presidential campaign. However, the OAT (34bp on 10yr bond spreads) remains inert, with positive yields beyond 10 years still luring final investors. Meanwhile, the widening of credit spreads remains limited with more volatility on high yield (+ 10bp in five sessions).

In addition to the rate dynamics, equities are propelled higher by the upbeat quarterly earnings releases, so that the main stock market indices are setting records in a context of low volatility. The S&P briefly broke above the 4,700 mark while the CAC 40 closed above 7,000, a record high. The VIX implied volatility index is trading around 16%. Excess liquidity remains a strong support for equities, as the earnings season is dominated by positive surprises. The pressure on historically high margins, however, is likely to intensify in the coming months.

Axel Botte

Global strategist

Main market indicators

G4 Government Bonds	08-Nov-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.73 %	-12	-4	-3
EUR Bunds 10y	-0.26%	-16	-11	+31
EUR Bunds 2s10s	47 bp	-4	-7	+34
USD Treasuries 2y	0.42 %	-7	+11	+30
USD Treasuries 10y	1.48 %	-8	-13	+56
USD Treasuries 2s10s	105 bp	0	-24	+26
GBP Gilt 10y	0.86 %	-20	-30	+66
JPY JGB 10y	0.06 %	-4	-3	+4
€ Sovereign Spreads (10y)	**08-Nov-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	34 bp	-3	+0	+11
Italy	114 bp	-17	+11	+3
Spain	69 bp	-4	+5	+7
Inflation Break-evens (10y)	**08-Nov-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	164 bp	+5	+13	-
USD TIPS	258 bp	+7	+7	+60
GBP Gilt Index-Linked	404 bp	+6	+10	+104
EUR Credit Indices	**08-Nov-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	89 bp	+2	+4	-3
EUR Agencies OAS	45 bp	+0	+3	+4
EUR Securitized - Covered OAS	44 bp	+1	+6	+11
EUR Pan-European High Yield OAS	320 bp	+11	-1	-38
EUR/USD CDS Indices 5y	**08-Nov-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	48 bp	-3	-4	0
iTraxx Crossover	240 bp	-22	-24	-1
CDX IG	49 bp	-3	-5	-1
CDX High Yield	285 bp	-21	-22	-9
Emerging Markets	**08-Nov-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	361 bp	+3	-1	+9
Currencies	**08-Nov-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.157	-0.31	+0.01	-5.29
GBP/USD	$1.354	-0.91	-0.55	-0.95
USD/JPY	¥113.39	+0.54	-1.01	-8.94
Commodity Futures	**08-Nov-21**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$83.2	-$1.5	$1.5	$32.6
Gold	$1 820.9	$27.6	$63.8	-$77.5
Equity Market Indices	**08-Nov-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	4 698	2.00	6.97	25.07
EuroStoxx 50	4 358	1.81	6.99	22.67
CAC 40	7 057	2.38	7.58	27.12
Nikkei 225	29 507	2.13	5.20	7.52
Shanghai Composite	3 499	-1.29	-2.60	0.74
VIX - Implied Volatility Index	16.49	0.49	-12.15	-27.52

Source: Bloomberg, Ostrum Asset Management

Additional notes

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