UNIGESTION

Multi Asset Macro Views

January 11, 2021

Come Back Song – Darius Rucker, 2010

GET READY FOR INFLATION

Inflation has been conspicuous in its absence for the past ten years. However, an analysis of recent developments in inflation drivers on both demand and supply sides suggests that it is about to make a comeback, albeit temporarily. We believe that this is a material risk and investors must respond. This is all the more the case as inflation assets are less favoured than growth assets for the moment. This inflation comeback requires preparation.

WHAT'S NEXT?

Inflation could normalise sooner than expected…

The economic situation in 2020 surprised on the downside in the first quarter, but also on the upside during the rapid recovery that followed. The US is a perfect example: if the Fed's nowcaster forecasts turn out to be correct, US growth in 2020 will have been close to 0%. This is a long way from the duration of the 2008 shock, and coordinated action by central banks and states played a key role. The power of this cyclical improvement should not mislead investors: the risk for 2021 is not really on the recessionary side in our view, but rather on the side of the natural consequence of rapidly accelerating economic activity: inflation.

It is vital that investors keep sight of the bigger picture. Continuing with the example of the US, the "PCE Deflator", so dear to the Fed, rose by just 1% in 2020, i.e. very low inflation to the despair of the central bank. The growth of this US price index was even negative for its hardest hit components such as leisure goods (-2.9%), medical equipment (-10.7%) and energy (-19%). However, this should not conceal the fact that some components have recently gained strength. Household equipment and vehicles saw their prices rise by 3.2% and 4.9%, respectively over the year. The implementation of vaccination campaigns should enable the components that are lagging behind to resume growth as energy prices rise. Given the levels reached by some components, it would not be surprising to see this US price index quickly return to its long-term average – and then exceed it.

... and even surprise to the upside in the coming months

Why do we see the risk of higher inflation increasing? Mainly for two economic reasons:

- On one hand, growth in world consumption should continue to recover and do so in a marked manner. Many investors are already well aware that household and corporate savings remain high. At the end of 2020, the wealth of American households had increased by USD 5.2trn in one year. We can expect that part of this increase in wealth will gradually be transformed into consumption as the health situation becomes clearer. Of this USD US 5.2trn, we can thus anticipate that 1trn will be gradually injected into the economy between 2021 and 2022, bringing the household savings rate to just under 10% of household taxable income, and adding 5% growth to US GDP. This additional growth should support the evolution of asset prices as well as goods and services. Our key scenario of 5% growth in world consumption should lead to global inflation of at least 4% in 2021 (against an expectation of 3%).
- On the other hand, this inflation could be accelerated by shortages reflecting the recent decline in economic activity. The strength of demand is there: the "New Order" component of the US ISM grew at a rate never seen before, the number of commercial flights soared in January and US rail freight indices returned to their December 2019 levels. It is not certain whether the disruptions that the supply side of the economic equation experienced in 2020 will allow it to cope with this rapid acceleration in demand.

Our Nowcaster and Newscaster inflation signals are not mistaken: for a few weeks now, they have been pointing to accelerating inflation, with our indicators now measuring an inflation risk that varies from "neutral" to "very high", whereas a month earlier they were fluctuating from "very low" to "neutral". The risk is there: how can we deal with it?

Inflation assets should gather investors' attention now

Is a sudden and temporary acceleration of inflation a problem for investors? To answer this question, it is necessary to consider the valuation of assets that traditionally benefit from inflation alongside current investor sentiment for these assets.

As far as sentiment is concerned, the situation seems relatively clear. When one analyses the beta of different types of "macro" hedge funds with traditional inflation hedge assets (commodities and inflation breakevens), their pessimism about the prospects of these assets is clear. In the fourth quarter of 2020, our inflation "basket", which combines these different assets into an investable portfolio, delivered a Sharpe ratio of 2.26 (compared to 3.9 for growth assets), yet this performance has made no impression on the hedge fund world. Their beta on these assets was negative and it has simply returned to zero as of late. There is therefore still plenty of room for this sentiment to continue its recovery.

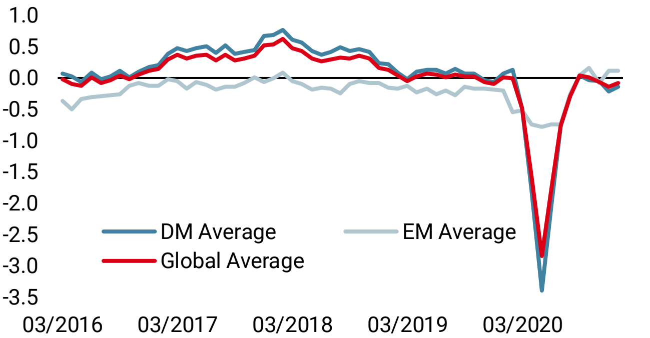
On the valuation side, inflation breakevens rose sharply in the fourth quarter: 5-year-in-5-year breakeven rates, the Fed's favourite indicator, rose from 0.85% in March to 1.96% at the end of December. The normalisation of inflation seems to be in prices. From the point of view of our valuation indicators, realised inflation being lower, breakevens even appear to be expensive. However, these same breakevens have a curious tendency to underestimate the escalation of inflation in periods of recovery: this was the case in 2009, 2012 and 2019. If there is an inflation surprise, this apparent high price still has a way to go. On the oil side, the term structure of oil does not anticipate a strong cyclical recovery: current prices (around USD52 per barrel) are perceived as temporary with expectations of a return to USD 49 by the end of 2021. Finally, gold is in firm contango, a typical sign of expensiveness. If we believe the "golden constant" of Erb and Harvey, the price of gold follows the consumer price index with remarkable consistency: when we compare them, gold is far from the high price that its contango suggests.

Inflation is making a comeback: let's be prepared for it

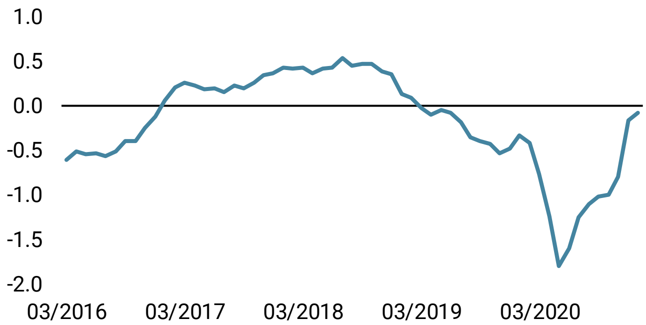
The recognition of a growing inflation risk is the most important change in our investment policy in recent months. This has led us to combine growth assets with inflation assets within our dynamic allocation: our preference at this stage is for inflation breakevens as well as energy and industrial metals, without having a negative view on government bonds for the moment.

UNIGESTION NOWCASTING

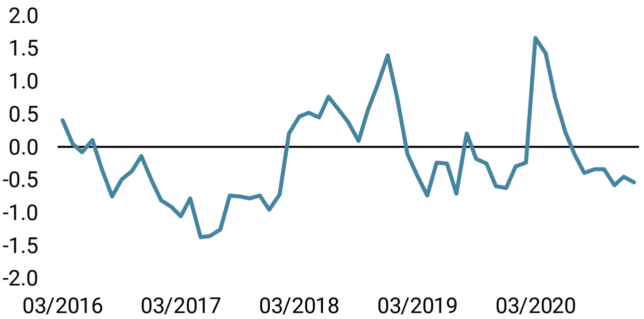
World Growth Nowcaster



World Inflation Nowcaster



Market Stress Nowcaster



Weekly Change

- Our World Growth Nowcaster increased last week, mainly as European data came out stronger, highlighting the improved growth momentum over the festive season.
- Our World Inflation Nowcaster increased again last week for most countries. Inflation risk now oscillates between high and very high.
- Our Market Stress Nowcaster declined as implied volatilities declined last week.

Sources: Unigestion. Bloomberg, as of 11 January 2021.

IMPORTANT INFORMATION