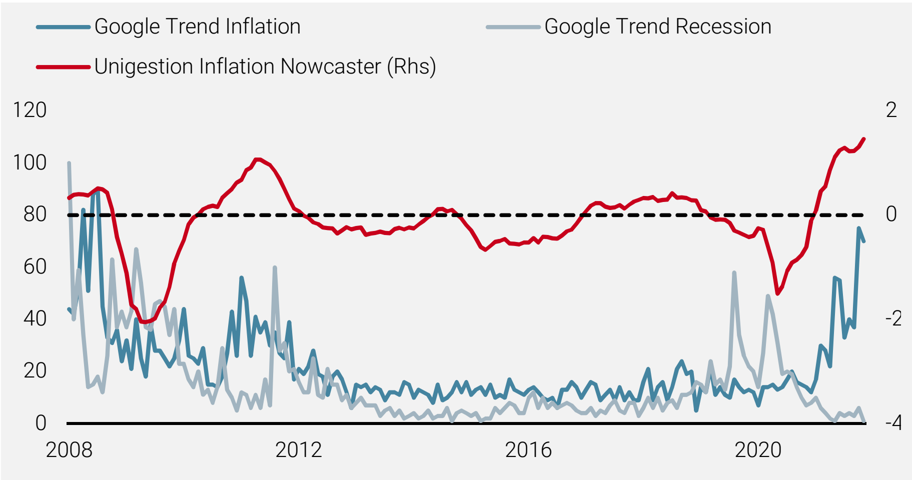
TAMING THE INFLATION BEAST IN 2022

December 2021

Like a phoenix rising from the ashes, inflation reemerged from the depths of Covid in 2020, accelerating throughout 2021 to heights not seen for decades in the Western world. This post pandemic surge was not expected, as evidenced by online searches for the term "inflation", which only started taking off mid-2021. Contrast this with our Inflation Nowcaster, which already had identified the potential for inflation surprises late in 2020 and early 2021.

Figure 1: Unigestion Global Inflation Nowcaster vs Online Searches Since 2008



Sources: Unigestion, Bloomberg, Google as of 30.11.2021. The Inflation Nowcaster index is a proprietary, real-time synthetic measure of inflation surprises. A reading above (or below) 0 of the Inflation Nowcaster signifies that inflation is growing at a higher (or lower) pace than expected inflation.

Guilhem Savry
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Inflation Sways the Markets in 2021

When it comes to assets performance, 2021 marked a seismic shift in perceptions as well as positioning in the markets. Still reeling from multiple waves of Covid and renewed restrictions during the winter months, the world seemed braced for another year of uncertainty on the economic front. As the situation started to improve thanks to vaccination rollouts, ample government support and seemingly limitless accommodation by the world's most powerful central banks, so did the financial narrative, which took on the form of "reflation".

In this environment:

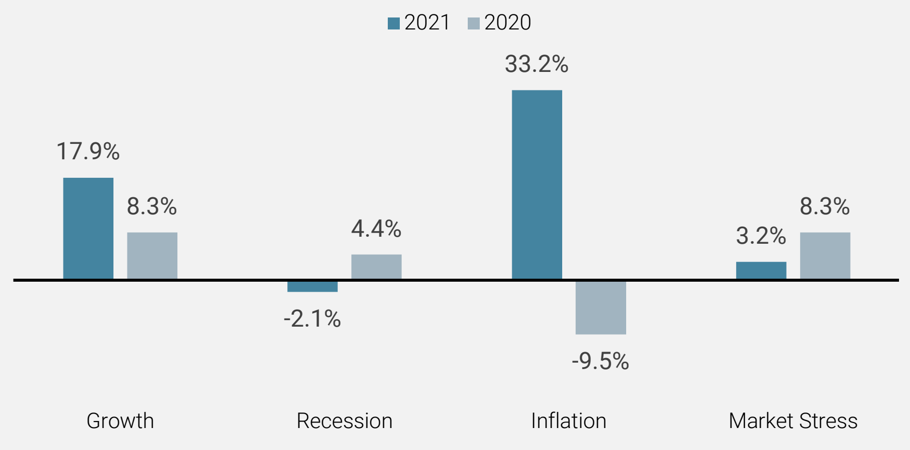
- Real assets outperformed
- Investors rotated from defensive to cyclical, and from nominal to real assets
- Dispersion within and across assets was considerable

This broad rotation across and within assets is closely mirrored by the performances of our macro baskets, a range of assets corresponding to key macro regimes, the themes that ultimately drive financial markets. Unsurprisingly, real assets within the "inflation" basket performed extremely well in 2021, as opposed to 2020, when the "recession" macro basket delivered positive performance and inflation-related assets declined significantly (Figure 2).

Key Points

1. Our Nowcasters detected inflation risk very early in 2021, prompting a shift into real assets
2. Inflation should cool in the new year, while growth remains healthy
3. In this environment we prefer US equities, Quality and Tech stocks and the US dollar in general

Figure 2: Unigestion Macro Basket Performance (2021 vs 2020)



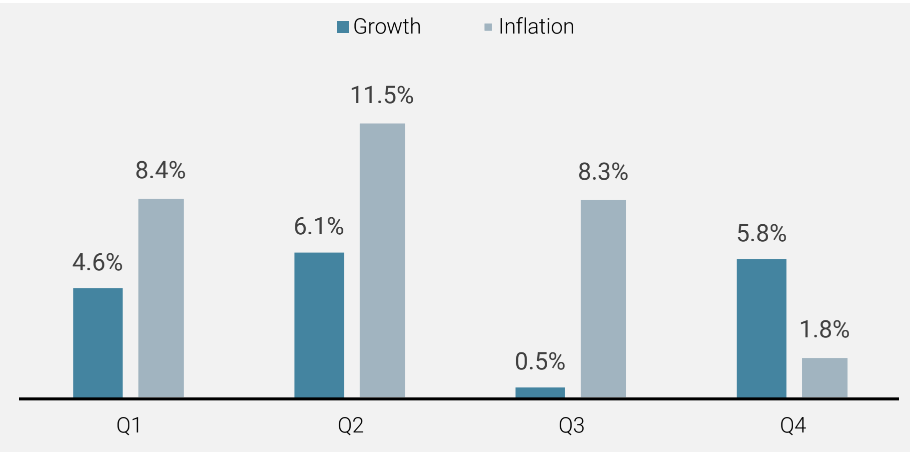
Sources: Unigestion, Bloomberg as of 30.11.2021. Growth Basket is a blend of HY and Global Equity indices, Recession Basket is represented by Duration, Inflation Basket is a combination of cyclical commodities and Inflation breakevens, Market Stress Basket is made up of the Vix future and AUDJPY. All Macro baskets are hypothetically derived and for illustration purposes only.

"This reflation narrative has persisted over the last twelve months, morphing into a full-blown 'inflation' story"

A Momentous Shift in the Macro Narrative

This reflation narrative has persisted over the last twelve months, morphing into a full-blown "inflation" story, with real assets outperforming growth assets most of the time in 2021.

Figure 3: Quarterly Performance of Unigestion Growth Basket vs Inflation Basket



Sources: Unigestion, Bloomberg as of 30.11.2021. Growth Basket is a blend of HY and Global Equity indices, Inflation Basket is a combination of cyclical commodities and Inflation breakevens. All Macro baskets are hypothetically derived and for illustration purposes only.

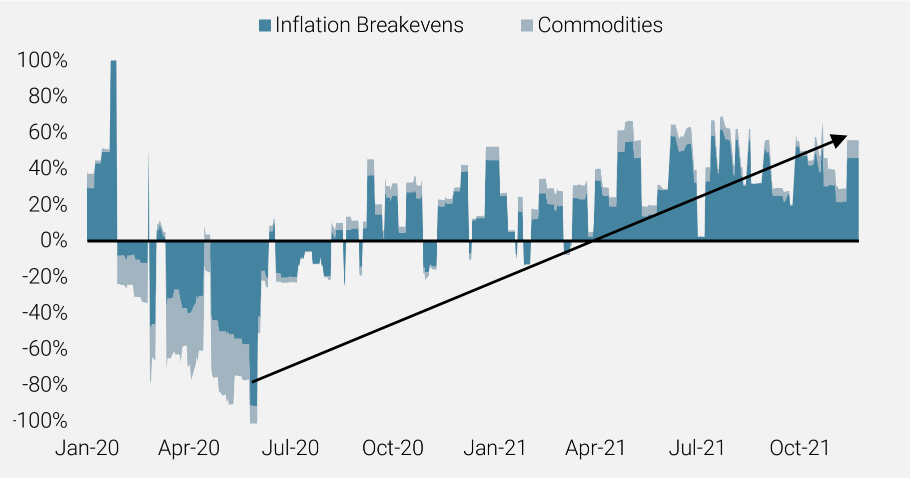
It only took one year for real assets to recover all their losses accumulated since 2014, reflecting the breadth and magnitude of the inflation surprise and its subsequent price adjustment.

How Did Adaptive Global Macro Navigate in This Terrain?

The fiscal stimulus - first used by households and companies as precautionary savings, then as consumption - added a demand effect to the initial supply shock, resulting in a monumental inflation surprise. Our Nowcasters, combined with a thorough analysis of the post-Covid supply chain - which exhibited low inventories and an overdependence on certain geographical areas and specific components – revealed at a very early stage that the risk of a supply shock would be the most important factor for inflation in 2021. We consequently adjusted our exposure:

The main change was in real assets, where we went from short to long within a couple of months (figure 4).

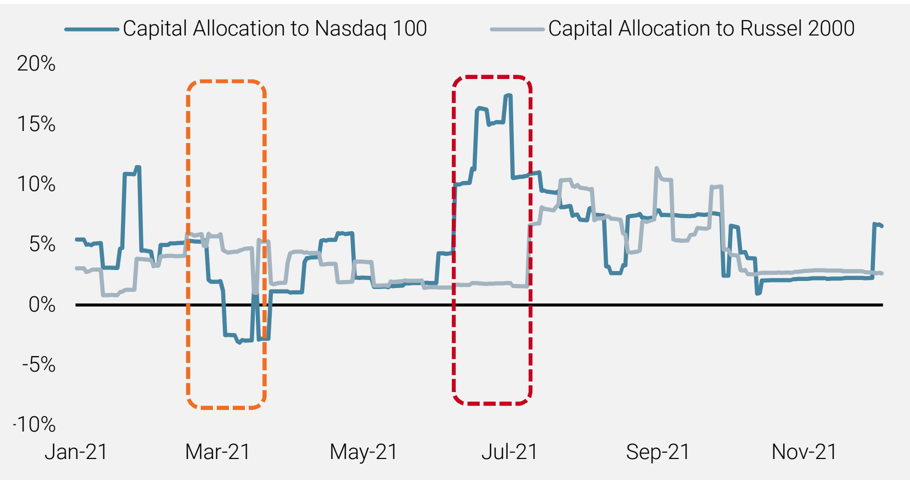
Figure 4: Historical Allocation to Real Assets in Adaptive Global Macro



Sources: Unigestion as of 30.11.2021

Our tactical tilt towards the reflation theme was not limited to real assets. Within growth-oriented assets, we also implemented key relative value trades. Early in the year, we went long the Russell 2000 vs the Nasdaq 100, mainly because of the higher implied duration embedded in the tech segment of the US equities market (figure 5). We also felt that unloved and under-owned sectors such as energy or financials would outperform, as evidenced through higher commodities prices and steeper yield curves. After five months of underperformance, coupled with a steep rise of 35 basis points in US 10yr real rates over that period - which considerably affects the tech sector - we turned more positive on the Nasdaq 100 mid-May and went long in our portfolio. By June, once the tech index had vastly outperformed the broader equity index, the strategy benefited from this tactical bet. As a result, the contribution of growth-oriented assets to the strategy's performance proved significant in H1 2021, illustrating the benefits of the flexibility in our views and the depth of our investment universe.

Figure 5: Historical Capital Allocation to Nasdaq 100 and Russel 2000

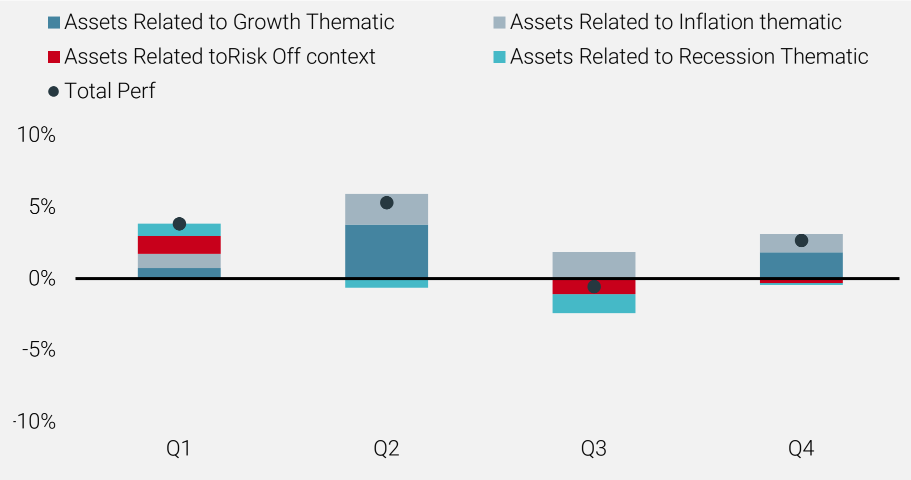


Sources: Unigestion as of 30.11.2021

The multiple contributors to performance in 2021 result from both directional and relative value trades. As we base our dynamic allocation on macro risk factors, the bulk of our performance came from assets related to inflation such as cyclical

"The multiple contributors to performance in 2021 result from both directional and relative value trades" commodities and inflation breakevens (Figure 6). Nevertheless, growth-oriented assets such as developed and emerging equities, credit spreads or cyclical currencies contributed positively as well, mainly in Q2 and Q4. Interestingly, real assets contributed more in aggregate than growth-oriented assets over the year (Figure 6).

Figure 6: Contribution to Adaptive Global Macro Strategy Performance by Assets



Sources: Unigestion as of 30.11.2021. Past performance is not a reliable indicator of future results, the value of investments can fall as well as rise and there is no guarantee that your initial investment will be returned. Returns may increase or decrease as a result of currency fluctuations. Please refer to the Important Information section for further information and disclosures.The performance of the Unigestion Adaptive Strategy is the hypothetical performance from 01.01.2015 to 31.08.2021, gross of fees chained from 01.09.2021 with the live performance of the first actual portfolio managed by Unigestion adopting this strategy. The hypothetical performance is based on the carve out of the most representative account of the Multi Asset Risk Targeted Composite, leveraged 5x to target an ex-ante volatility of 10%. Performance returns are shown net of management fees, with dividends reinvested. Please refer to the GIPS Compliant Presentation at: https://www.unigestion.com/unigestion-global-macro-10-target-volatility/

No "Volcker Massacre" in 2022

Our central scenario for 2022 calls for an easing in supply bottlenecks, lower growth, and tighter financial conditions, which in turn should cool inflation. As such, we do not expect Powell to tighten anywhere near as shockingly and aggressively as Volcker did in the late 1970s, where the fight against inflation was his only priority. Rather, we see a gradual and telegraphed reversal, where employment matters most, much like the one engineered by Yellen back in 2016.

With the market having absorbed three rate hikes next year, starting in March or May, the question for investors is whether they expect more or fewer hikes. We are squarely in the camp of fewer.

"…we see a gradual and telegraphed reversal, where employment matters most, much like the one engineered by Yellen back in 2016"

Our core view for next year: Inflation normalises

"Cool It Now": Inflation Peaks and the Cycle Extends

Growth maintains a healthy, above-potential level as the labor market continues to recover

Inflation pressures cool significantly as supply issues are progressively resolved and demand normalizes

Monetary policy is **less accommodative** but central bankers **walk back** strong hawkish tilt

Dispersion across and within assets

- Rising real rates will benefit some markets, hinder others
- Real assets will see more tailwinds than headwinds
- US Dollar should be well-supported by growth differentials vs DM peers

Old and new trends

- Tech sector will continue to post impressive results and attract investors
- ESG will drive more and more allocators, to the benefit of the carbon market
- Improvement in Chinese macro fundamentals would be boon for risk broadly

For 2022, monitoring real rates and the US yield curve will be key to assess to what extent the expected tightening by the world's major central banks could derail the bullish trend in both earnings growth and returns for growth and real assets.

"For 2022, monitoring real rates and the US yield curve will be key"

What if We are Wrong?

We see two alternative scenarios that could derail our core views for 2022:

1. The dreaded "Monetary Policy Mistake"

In this scenario, inflation peaks later than we anticipate, leading central banks to tighten earlier and more than expected. Worse, central banks could slam on the breaks even sooner, shifting to a narrative of "durable" inflation, even though it has already peaked and is starting to fall. As a result, bond yields would rise across the board, punishing growth assets, triggering a vicious cycle of position liquidation, and deleveraging.

2. Covid lingers, gets worse

Vaccine effectiveness could wane, new and more dangerous variants would appear, leading to increased lockdowns and restrictions on a global scale. Households and companies would then pull back into "precautionary savings" mode, while central banks start stimulating massively again to avoid deflation and cascading defaults, pushing bond yields significantly lower. Meanwhile, governments ramp up fiscal stimulus again, issuing huge amounts of debt.

Two alternative scenarios that would challenge our core view:

"OOPS!... I DID IT AGAIN"
Monetary Policy Mistake

- Inflation **peak postponed**
- Central bankers **tighten more than anticipated** to reign in prices
- Valuations of **growth assets challenged** at the same time **bond yields rise**
- Market turmoil leads to investor **deleveraging**

"BACK TO BLACK"
Ineffective Vaccine

- Economic **contraction** takes hold again following multiplication of lockdowns across the world
- Corporates and households **increase precautionary savings**
- Central banks stimulate massively again to avoid deflation and cascading defaults, pushing **bond yields down**
- Governments issue more debt in order to finance even more **fiscal stimulus**

Navigating in a Year of Normalisation: From "Low and Rising" to "High and Falling"

We see next year as more challenging for beta, hampered by tighter financial conditions combined with waning fiscal and monetary support, as well as higher growth uncertainty due to the uneven sanitary crisis.

Against that backdrop, we would prefer:

- Quality segments in equities that offer solid earnings growth and higher visibility in terms of profitability
- US equities versus the rest of the world, thanks to a more flexible US policy mix and its corporate leadership in key sectors
- A US Dollar that should benefit from stronger US GDP and higher liquidity in its capital markets, both of which should drive flows into US assets
- We would also be less exposed to real assets than we were in 2021, as current pricing in both inflation breakevens and energy prices reflect a durable expansion period in the global cycle, which in our view, given the potential headwinds identified for next year, seems too optimistic.

"The US Dollar should benefit from stronger US GDP and higher liquidity"

Macro

- **Inflation** remains above CB targets but **decelerates**
- Global **growth** converges towards **potential**
- **Fed normalises** policy but at a **slower** pace than current market pricing
- **Risk** scenario is **too tight** on monetary policy

Themes

- Real rates higher
- Energy prices higher
- US Equities > Rest of World
- Growth > Value
- Real assets' pricing exhibits too large risk of inflation

Trades

- Long Quality/Tech
- Long USD vs G10
- Long US Equity
- Long Carbon
- Short Inflation Breakevens

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