MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 037 // **September 20, 2021**

Topic of the week: A critique of the transitory inflation thesis

- **The Fed's narrative is at odds with survey evidence of building price pressures;**
- **We review the five arguments of the Fed presented at Jackson Hole and conclude that inflation could prove persistent;**
- **Extreme price gains may be a symptom of broad-based supply issues rather than reopening demand;**
- **Wages and consumer inflation expectations may feed into higher inflation going forward;**
- **The return of global disinflation is all but certain as the world embarks onto energy transition.**

Market review: China: the 2022 Black Swan?

- **China credit risk can no longer be ignored;**
- **FOMC: markets await 2024 dot plot;**
- **Upward pressure on bond yields, nervousness in equity space;**
- **Spread compression continues in Europe credit markets.**

Chart of the week

The Evergrande events weighed heavily on the Chinese High Yield Index. The average rate on the index exceeded 14% for the first time since 2012 (NB: Evergrande represents 2.5% of this index).

This is only part of the adjustment, risk premiums have also strained very sharply on other assets: Chinese equity market, then, through contamination, equity markets in other countries.

Figure of the week

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Source : Ostrum AM

The price of natural gas in Europe (quoted in Euro per megawatt hour). The average over the past decade, and the price at the beginning of the year, was around €20.

Stéphane Déo
Head of markets strategy

Axel Botte
Global strategist

Zouhoure Bousbih
Emerging countries strategist

Aline Goupil- Raguénès
Developed countries strategist

● Topic of the week

A critique of the Fed's transitory inflation thesis

The Fed's narrative on inflation dynamics appears dubious. The Fed maintains that demand around the reopening has been the main driver of elevated inflation. Instead, survey evidence points to supply constraints as the dominant factor in the sharp increase in prices. In this piece, we examine the Fed's five arguments pertaining to inflation presented at Jackson Hole as the FOMC prepares to meet on September 22nd.

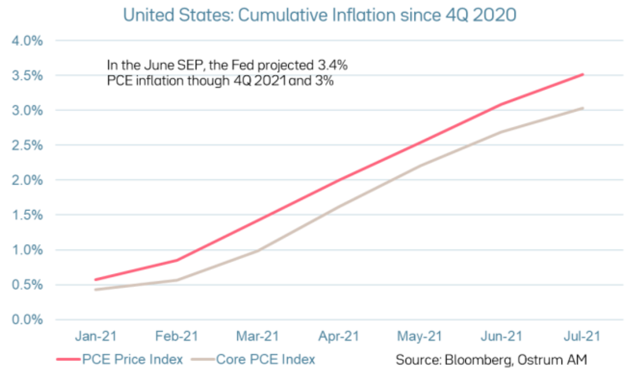
Fed narrative at odds with inflation reality

Fed policymakers consider that the swift reopening of the economy, from last summer through spring this year, has been the main driver of the sharp acceleration in inflation. To put the inflation spurt in context, the Fed's preferred inflation measure (derived from the headline personal consumption expenditures price index or PCE) stood at 4.2% in July, well above its 2% longer-run objective. The consumer price index (CPI), used for reference by inflation-linked Treasury bond markets, was even higher at 5.3% in August.

It is the Fed's belief that inflation concerns must be tempered by a number of factors. Elevated readings are likely to prove temporary according to Fed members even as thirteen of the eighteen FOMC participants acknowledge upside risks to inflation.

Fed to revise 2021 inflation forecasts upwards

In the Fed's quarterly summary of economic projections, forecasts for both measures of inflation (headline and core) are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. In June, US central bankers forecasted headline inflation to reach 3.4% in 2021 whilst core inflation would fetch 3%. Looking further ahead, US PCE inflation is projected to slow to just over the 2% target in 2022 (2.1%) and 2023 (2.2%). Core PCE forecasts two years out are just one tenth lower than the headline inflation projections.



In the second quarter of 2021, the headline PCE index was up 2.54% from the fourth quarter of 2020. However, the monthly PCE series (3.51% up to July) already suggests an overshoot of the Fed's year-end forecasts of 3.4%. The same is true of the core measure of inflation that stands at 3.03% with 5 months remaining. In other words, inflation would need to fall to zero for the remainder of the year for the Fed projections to come true. Fed policymakers will thus have to raise their 2021 forecasts.

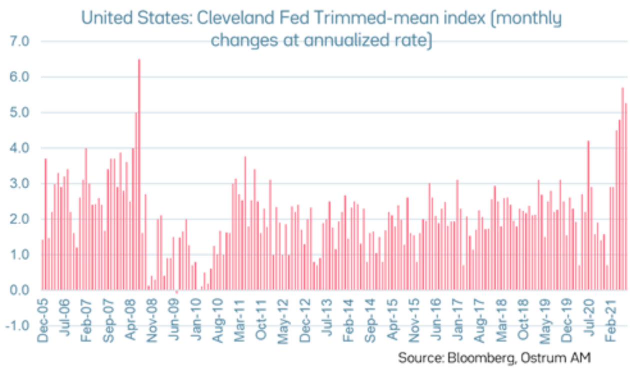
Review of the Fed's arguments

Inflation dynamics are complex. At the Jackson Hole symposium, Fed chair Jerome Powell put forward five arguments to explain his view of transient inflation. We examine the Fed's arguments and provide some alternative perspective on the inflation outlook.

1. The Federal Reserve notes the absence, so far, of broad-based inflation pressures.

The Fed argues that the inflation spurt is traceable to a relatively narrow group of goods and services affected by the pandemic and the reopening of the economy. Durable goods and energy prices had a large contribution to inflation. Likewise, hotel rooms and airplane tickets, which plummeted as tourism came to a halt, have now moved back up close to pre-pandemic levels.

The reopening of the US economy certainly allowed for price normalization across a range of hard-hit economic sectors. A word of caution is needed here. Prices were sometimes unobservable, as business activity had fallen to zero in parts of the economy. Measuring inflation in itself is quite a challenge. That being said, some inflation measures that strip out the largest price swings either way suggest that most prices now rise at an above-target pace. The Cleveland Fed's trimmed-mean index showed monthly changes since this spring well in excess of pre-pandemic average levels. In fact, the four largest monthly readings of the trimmed-mean index in the past ten years occurred in the May-July 2021 period. On this measure, 'middle' inflation averages 3.8% so far in 2021. In sum, the current rise in inflation is not simply a by-product of the reopening of sectors hit hardest by the pandemic. Under the surface, leaving extreme swings aside, there are indeed broad-based price pressures building.

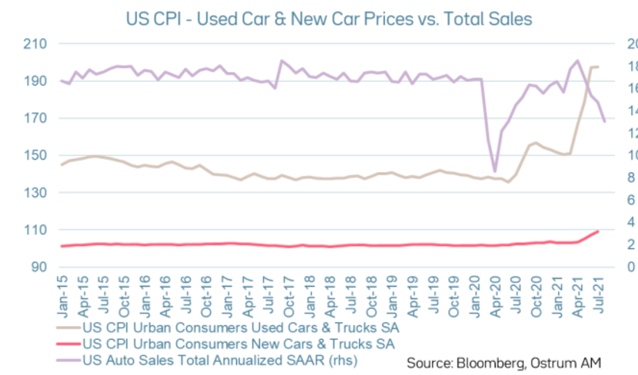


2. The Fed expects inflation to moderate in higher-inflation items

The Federal Reserve policymakers expect the prices of particular goods and services most affected by the pandemic and the reopening, to moderate as shortages ease. Used car prices, for example, appear to have stabilized albeit at a high level.

The example of the auto industry is quite telling. The surge in second-hand car prices is indeed concomitant with the reopening and the desire of American households to resume travelling. Government transfers to households in March indeed spurred demand contributing to outsized gains in used car prices. At the same time, car rental companies, which had sold their fleets as activity collapsed in the wake of the Covid outbreak in 2020, sought to purchase vehicles ahead of reopening.

However, the rise in prices is not only linked to a peak in demand. It is important to distinguish between supply and demand factors in the auto price jump. The increase in used car prices is traceable to supply bottlenecks. Early on, carmakers chose to restrict production as metals prices shot higher and a significant shortage of semiconductors developed in the entire world. The development of work from home had spurred demand for electronic devices at a time when car manufacturers had not fully secured their procurements of chips. Impediments to world trade including skyrocketing freight rates may also have weighed on car imports. The shortfall of production of new cars logically displaced consumer demand on used cars. Automotive output started to recover but the latest communication from global manufacturers including Daimler, GM, and Stellantis suggest that the penury of semi-conductors will curtail production well into 2022. Taiwanese semi giant TSMC recently warned that shortages will last at least until the end of 2022 and incidentally decided to raise prices by 20%.



Thus, used car price increases have started to feed into new car prices. US car manufacturers may aim at limiting supply of mid-range models to focus on higher-margin higher-priced vehicles. In any case, demand cannot explain the price surge since the spring. After a horrendous year for car sales in 2020, sales moved up to 18mn this spring as the economy reopened. The US auto sales average 16-17mn in equilibrium, so 18/18.5mn readings represent relatively high demand. However, as prices continued rising, demand collapsed to a mere 13mn units at annualized rate in August. Hence, excess demand driving prices higher mostly reflect supply conditions.

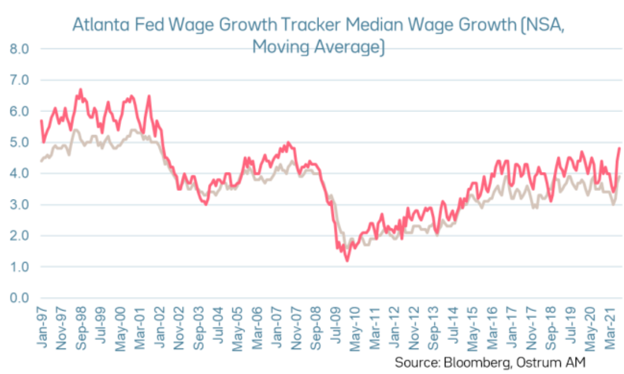
The example of the automotive sector is one of many instances where supply is constrained. The beige book and many other supply-side surveys have long reported shortages in a range of materials, higher input prices, hiring difficulties and extended lead times. In sum, inflation may moderate in high-inflation items but persistent supply-chain problems, as is the case in the auto industry, may persist and spark another round of price hikes. The most extreme price increases may only be a symptom of a broad-based supply shortage.

3. Wages.

The Fed must have an idea of the level of wage growth consistent with its 2% inflation objective. There is a risk that, if wage increases remain persistently higher than productivity gains and inflation, businesses would seek to protect their margins by passing those increases on to customers, a process sometimes deemed a "wage–price spiral". Wages are hard to track, given compositional changes in the labor force, in terms of geography, demography or skill level.

The Atlanta Fed wage growth tracker is a well-established pay gauge. It tracks pay levels of intertwined cohorts of workers over time using the same data set as the BLS' average hourly earnings measure. Median wage growth is 3.9% from a year ago in August. This is actually on par with pre-pandemic cyclical highs. Furthermore, the report suggests that pay may have risen even faster for low-skill jobs. Job switchers, workers that have changed jobs in the past 12 months, were able to cut annual increases of 4.8%.

In addition, one key feature of the pandemic recession is that wage growth did not slow materially in the wake of record job losses in the spring of 2020. This is unusual. In previous recessions, slow job recoveries had caused sustained low wage growth. Productivity gains did bounce in response to corporate restructuring, but unit labor costs have not turned negative on a year-over-year basis. In other words, worker pay continues to outpace labor productivity, which has the potential to raise the minimum level of inflation in the US. In parallel, the July 2021 New York Fed SCE survey of income expectations reveals that unemployed persons with sub-college education have raised their reservation wage since the start of the pandemic by close to 12% (compared with November 2019). Higher reservation wages may be a reason why labor force participation continues to fall short of 2019 levels. Again, a shortfall in labor supply may drive wage growth and inflation higher. It is nevertheless unlikely that a wage-price spiral comparable to the high inflation of the 1970s could develop. The share of unionized workers has indeed declined considerably in the past fifty years. That said, income inequality has become a key political issue and the Biden Administration could weigh in to foster faster pay rises. In sum, there is little evidence of as shortfall in wage gains that could undermine the ability of the Fed to reach its inflation objective.

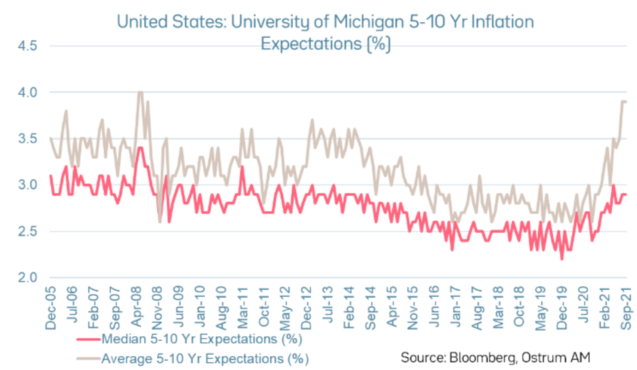


4. Longer-term inflation expectations

The Federal Reserve emphasizes that anchoring longer-term expectations at 2% is important for both maximum employment and price stability. The Fed has built a common inflation expectation (CIE) measure combining the surveys of professional forecasters, market-implied inflation measures (e.g. TIPS breakeven inflation rates) and consumer surveys. The composite index recently showed a reversal of the prolonged earlier decline and is now at levels more consistent with the 2 % target.

Though the Fed notes that long-term inflation expectations have moved much less than actual inflation and near-term inflation expectations, the consumer survey of University of Michigan showed a sharp run-up in inflation forecasts of US consumers.

Average 5-10 year inflation expectations are running at a 3.9% clip (August), the highest it has been in three decades. The median response is less extreme at just 2.9%, but it may already be out of line with the Fed's desired level. Household expectations may be hard to interpret as consumer sentiment on goods prices is mostly based on frequently bought items, which prices may be volatile (e.g. gasoline).



Equally, market-based expectations are biased downwards by monetary policy, and in particular quantitative easing. The commitment to keep rates low for a prolonged period of time may have skewed inflation expectations to the downside if expectations follow a neo-Fisherian framework.

The role of expectations of economic agents is a hypothesis of economic models popularized in the 1970s. This is only a hypothesis. It is far from certain that households are able to integrate price dynamics in their labor supply for instance, let alone influence the price level by demanding higher wages for instance. Recent research[1] using microeconomic data at the US state level nevertheless concludes that anchoring long-term expectations is central to price

[1] The Slope of the Phillips Curve: Evidence from U.S. States. Jonathon Hazell, Juan Herreno, Emi Nakamura & Jon Steinsson, April 2021.´

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dynamics. Furthermore, most household surveys suggest that the desired level of inflation for individuals is close to zero. Inflation is always seen as a cost, especially as it relates to non-discretionary spending.

Economics is in need of a 'good' inflation theory. The monetarists' view can no longer be tested as the bank reserve increase is largely traceable to regulatory holdings. The imperfect mobility of factors can partly explain current price tensions (Wicksell). One has to assume that price adjustments are easier on the upside (given the downward rigidity of wages for instance). In turn, we lack an empirical study of the formation of prices from the point of view of producers, based on costs and a margin behavior. A solid modelling of corporate pricing behavior would be much more useful than price dynamics based on household expectations or market-determined breakeven inflation rates.

The Fed puts considerable (possibly too much?) faith in inflation expectations as a determinant of price developments. The latest surveys suggest that inflation expectations may no longer be assured, which should ignite a response from the Central bank.

5. The prevalence of global disinflationary forces over the past quarter century

Inflation has remained low, even in good economic times of the past 30 years or so. Low and stable inflation may have resulted from deepening use of technology (to better manage inventories for instance), increased globalization of supply-chains and demographic factors. These factors are unlikely to go away, so that downward price pressures may resume.

However, the collapse of the Soviet Union in the 1990s and the inclusion of China in WTO represented massive supply shocks that cannot be repeated on this scale. Instead, Chinese consumer demand will weigh on prices and Renminbi appreciation should reduce imported disinflation in the US. Furthermore, global supply chains may have become overly complex so that relocations could make sense in select industries (for strategy or national security reasons). Indeed, China, the US and Europe are battling to expand production capacity in the semiconductor industry, which is dominated by Taiwan and South Korea. For this reason, there could be increased competition for skilled labor at the global level.

The use of new technologies in the retail sector is highly disinflationary. Technology cuts prospecting costs for consumers. The large online retailers have gained considerable retail market share, hence becoming a highly political issue in the United States or in China where the massive collection of personal data sparked the recent crackdown on the sector. Ultimately, giant online retailers will have to face some form of antitrust regulation. The economies of scale currently passed on to consumers are significant, so that limits to their market shares could turn out to be inflationary. The dividends of globalization in the form of cheap imports would thus disappear.

The fight against climate change requires a rapid increase in energy transition investments. Many jobs will be destroyed; new skills will be required with a growing risk of supply and demand mismatch in the labor market. The replacement of the current stock of capital with a new less-energy intensive stock is an extremely complex problem, with no guarantee of productivity gains to be used to compensate the 'losers' in this transition. The electrification of the auto industry and the development of renewable energy production imply a very large increase in the consumption of commodities (copper, aluminum, manganese, lithium, etc.). Copper demand is forecasted to increase by 150% by 2040, lithium consumption may be multiplied by 20. It is obvious that prices will set the priorities. It is not at all certain that the newt quarter century will resemble the (more or less) 'happy' global disinflation of the past 25 years.

Conclusion

The Fed's transitory inflation thesis, which underpins current monetary accommodation, is increasingly at odds with survey evidence and price measures. Inflation pressures appear broad-based and mostly traceable to supply constraints rather than stronger demand around the reopening. Wage growth has picked up. Household price expectations have moved up to levels that may no longer be consistent with the Fed's price stability objective. Lastly, the assumed return of global disinflationary forces is dubious in the context of the energy transition problem.

Axel Botte

Market review

China: the 2022 black swan?

Financial markets must take account the Chinese risk, but the reach for yield keeps suppressing credit spreads in Europe.

As Fed policymakers respect the blackout period before the September 22 FOMC the financial markets appear more concerned with geopolitical risk and financial risk. Financial markets anxiously await the outcome of budget negotiations underway in the United States. Tensions arose between France and the United States over the sale of nuclear-powered submarines to Australia. The US maneuver is clearly aimed at containing Chinese expansion in the region. In China, the near bankruptcy of real estate developer Evergrande raises questions about credit risk in China amid a sharp slowdown in activity. In addition, the quarterly expiration of equity derivative products caused some nervousness towards the end of the week. The 1% weekly drop in European stock market indices occurred in the context of high intraday volatility. The decline in metals (a ton of iron dropped below $ 100) looks like a knee-jerk reaction to Chinese woes. In turn, low inventories of oil and gas are driving energy prices higher.

The US economic situation remains solid. Retail sales rebounded by 0.7% in August, a surprisingly strong increase given the current level of demand for goods. According to Redbook data, weekly sales figures remain upbeat in September. However, the US consumer is faced with rising inflation in durable goods and real estate. The sustainability of the US economic cycle will depend heavily on price developments. Inflation and the federal debt ceiling weigh on ongoing budget discussions in the US Congress. In addition to the $ 500 billion bipartisan bill, the second plan of infrastructure spending will likely be downsized to $ 1.5T billion over ten years. The initial fiscal stimulus plan amounted to $ 3.5T. The FOMC meeting scheduled for September 22 therefore will be held in a highly uncertain context. The tapering announcement will probably be delayed to November or December, but the market will pay attention to new Fed Funds rate forecasts for 2024. We can bet that Jerome Powell will use the appropriate language to smooth out the impact of these new rate projections.

In fixed income markets, the T-note crept higher to 1.37% at the end of the week. The CPI inflation print (5.3% in August) had sparked a rally to 1.26% before the retail sales release reversed the trend. The 5s30s spread (54bp) narrowed sharply by 7bp. The 5-year bond's underperformance is indicative of market participants' caution ahead of the Fed's rate forecast for 2024. In the euro zone, the Bund broke through the -0.30% threshold. Rumors of an upward revision of the inflation outlook by the ECB and a rate hike as early as 2023 livened up trade. The steepening trend may have legs with no prejudice, so far, to sovereign spreads. The Italian 10-year BTP briefly traded below the 100bp mark before closing the week at 101bp. Note, however, that the Italian government plans to spend € 3.5 billion to help households manage energy bills. France has decided on a similar aid plan for households amid rising natural gas prices. The numerous sovereign and agency bond issues are still met with strong investor demand, notably the green bonds of the EIB (5 years), the KfW and the European Union launched this week. The EU financing program includes a further € 26bn in bond issuance in the upcoming quarter to fund the NextGen stimulus plan. Greece is said to consider launching a green GGB.

Corporate credit markets fared well last week. Spread compression continues, with the search for yield primarily focused on hybrid securities that tightened by 8bp or subordinated financial debt. Meanwhile it's quite clear that the future of the European corporate credit market is green. Primary activity valued at € 15 billion in transactions gives pride of place to green or sustainable emissions (13 of the 23 transactions of the week).

As concerns European high yield, the primary market remained active with € 2.3 billion in transactions, most of which was new financing (€ 2 billion). Spreads continue to tighten in line with the investment grade compression theme. The average spread on European high yield narrowed by 9bp to 281bp. Activity also remains strong in the secondary market. News about a German real estate company, however, caused a bout of volatility last Friday. Hedge funds are taking action to push prices lower. The trends are similar in the United States where high yield spreads declined by 8bp. In Asia, the situation of Evergrande is worrying. Yields in the Chinese high yield segment stood at 14% compared to 6-8% at the start of the year. The big Chinese banks are exposed and other real estate developers are attacked on the stock market by mimicry. The PBoC tried to calm the markets by injecting liquidity. It will be essential to monitor the development of capital flows, any disorderly exit would undoubtedly spark a reaction from the monetary authorities.

Finally, equity markets had a volatile week without any real trend but the nervousness of market participants is palpable. The rebound in crude prices above $ 75 favors the energy sector whilst cyclical value stocks beat the market in Europe. In addition, upward pressure on bond yields at the end of the week weighed on the US equity indices.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	20-Sep-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.72 %	-1	+3	-2
EUR Bunds 10y	-0.33%	+1	+17	+24
EUR Bunds 2s10s	39 bp	+2	+14	+26
USD Treasuries 2y	0.21 %	+0	-1	+9
USD Treasuries 10y	1.31 %	-1	+6	+40
USD Treasuries 2s10s	110 bp	-1	+7	+31
GBP Gilt 10y	0.79 %	+5	+27	+60
JPY JGB 10y	0.05 %	+1	+4	+3
€ Sovereign Spreads (10y)	**20-Sep-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	34 bp	+1	-1	+11
Italy	103 bp	+1	-2	-9
Spain	65 bp	-1	-6	+3
Inflation Break-evens (10y)	**20-Sep-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	153 bp	-5	+16	-
USD TIPS	231 bp	-7	+4	+32
GBP Gilt Index-Linked	376 bp	0	+20	+76
EUR Credit Indices	**20-Sep-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	83 bp	-1	-1	-9
EUR Agencies OAS	41 bp	-1	-2	+0
EUR Securitized - Covered OAS	37 bp	+1	-1	+5
EUR Pan-European High Yield OAS	281 bp	-8	-16	-77
EUR/USD CDS Indices 5y	**20-Sep-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	51 bp	+7	+4	+3
iTraxx Crossover	253 bp	+25	+15	+12
CDX IG	54 bp	+7	+4	+3
CDX High Yield	288 bp	+12	-5	-6
Emerging Markets	**20-Sep-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	343 bp	+2	-12	-9
Currencies	**20-Sep-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.171	-0.84	+0.09	-4.23
GBP/USD	$1.365	-1.34	+0.21	+0
USD/JPY	¥109.49	+0.47	+0.26	-5.65
Commodity Futures	**20-Sep-21**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$73.7	$0.2	$9.0	$22.8
Gold	$1 757.9	-$35.9	-$23.2	-$136.4
Equity Market Indices	**20-Sep-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	4 433	-0.57	-0.20	18.02
EuroStoxx 50	4 016	-4.14	-3.16	13.05
CAC 40	6 395	-4.23	-3.49	15.19
Nikkei 225	30 500	0.39	12.91	11.13
Shanghai Composite	3 614	-2.41	5.45	4.06
VIX - Implied Volatility Index	26.31	35.83	41.76	15.65

Source: Bloomberg, Ostrum Asset Management

Additional notes

Ostrum Asset Management

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