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INVESTING TOGETHER

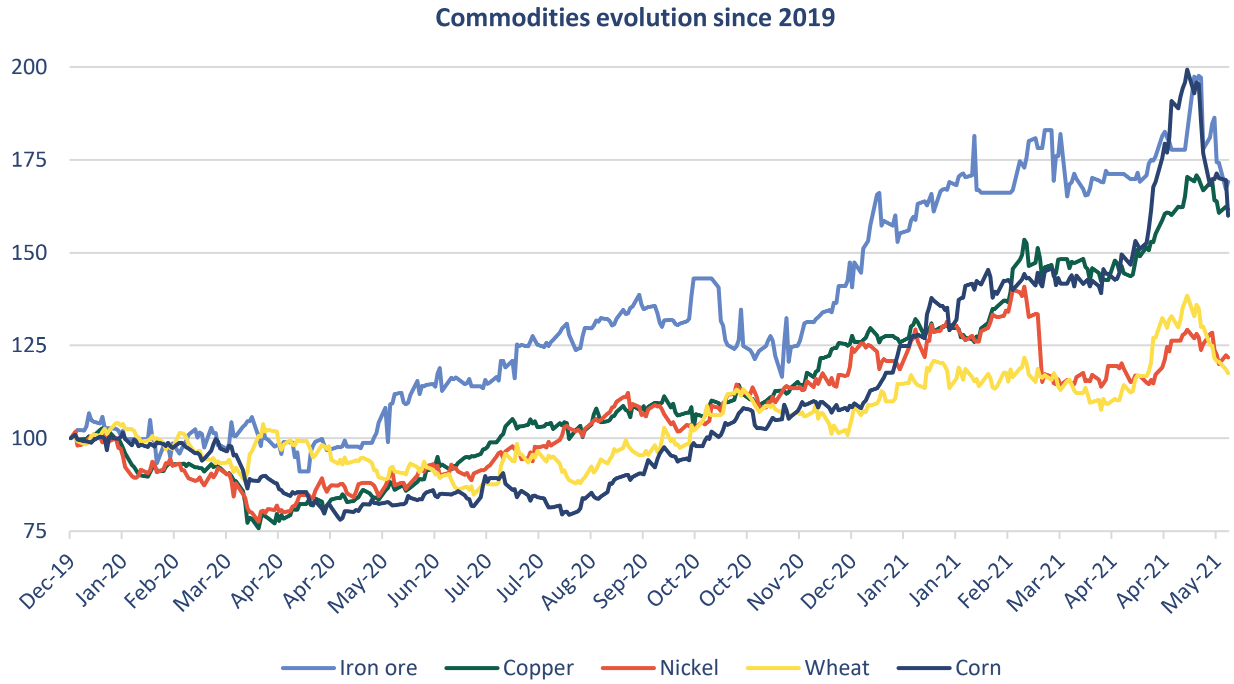
Market flash: Inflation surprise

June 2021

Inflation: early signs

Inflation is now, one of the main sources of concern within the financial market industry. There is indeed a lot of uncertainties regarding the transitory nature of these inflationary pressures.

For several months now, signs of inflation have increased in our economies. One of the most distinct signs of pressure emerged from the commodities market, currently displaying significant price increases within raw materials. Since the end of 2019 (i.e. before the start of the crisis associated with the pandemic), iron ore has increased by 69%, copper by 61%, and nickel by 21%, and these increases are not limited to industrial metals but also affect agricultural raw materials with wheat and corn increasing by 17% and 60% respectively.



Source: Bloomberg. Evolution of future contract prices (in $)

The Real Estate market is in a way very similar, it has pushed wood prices to extreme levels (+229% since the end of 2019…) and central banks to consider measures to limit loan access in countries such as New Zealand and Canada. The strong demand for goods (offsetting the closure of a large part of services) also caused a break in the semiconductor supply chains, leading once more to inflationary tension on several categories of goods (Electronics, second-hand cars, etc.)

So far, energy has been the only commodity that has not shown a huge increase over the period (+3.73%), this is mainly due to a sharp decline in commercial flight demand since March 2020.

Implications in the economy

Consequently to these price hikes, **production costs are soaring in our economies** (US PPI up 9.5% over 12 months, highest since July 2008) which **should have repercussions**, at least partially, **on consumer prices** given the current household savings rate.

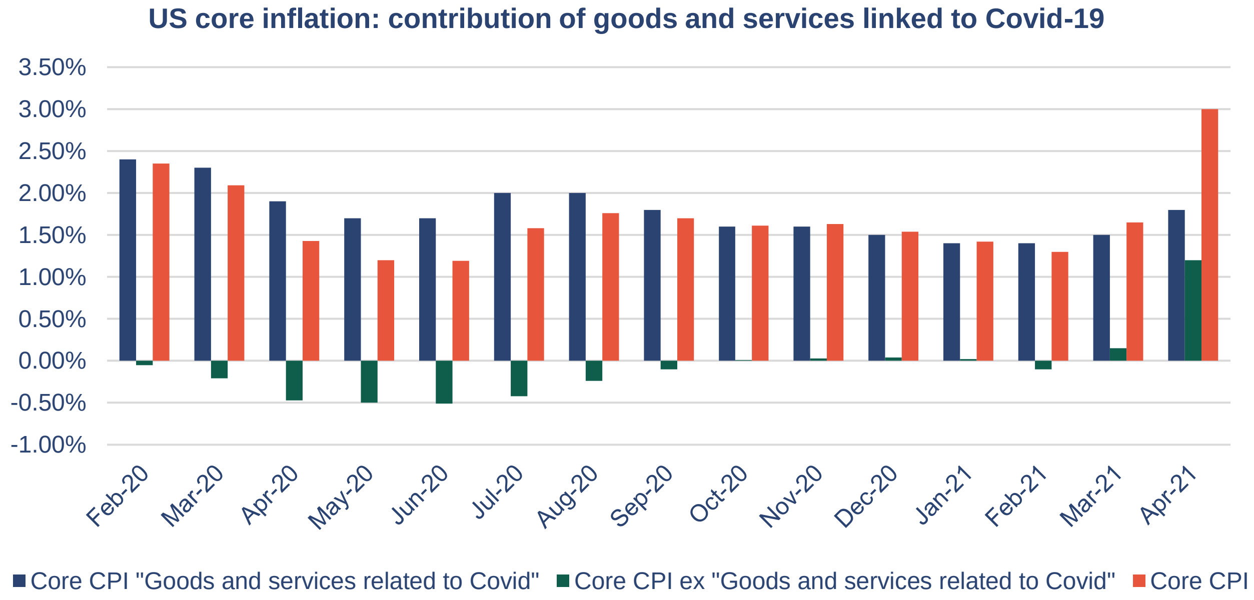
Since last April, **monetary and fiscal policy measures** conducted by central banks and governments **have been key drivers of** this sudden inflation: rate cuts (for central banks still having this possibility) balance sheet size increases, and extensive fiscal stimulus not seen since the post WWII era. It is reasonable to **expect monetary policies to become more restrictive**, however, **this should be done gradually to not "damage" the recovery**, even if it implies taking the risk of being a little too late.

If we add base effects to all of this, which also have and will continue to have positive effects on inflation in 2021, the conclusion seems evident: if there is no inflation now, then there will never be, as everything seems aligned for inflation to rebound strongly. **Is inflation going to be on average at levels not seen for 15 years in the main developed economies?** We lean in this direction.

Is inflation a momentary effect?

Nonetheless, **the most important question today concerns the transitory or non-transitory nature of this inflation.** If we listen to the US Federal Reserve's speech and if we share its interpretations, then yes, this inflation is transitory, and it is unrealistic to hope for greater structural inflation as long as the labour market remains so far from full employment.

Indeed, **it is very likely that much of the inflation we are currently experiencing is transitory.** Second-hand car prices will normalise once supply issues are resolved, **base effects will naturally disappear,** and the US fiscal stimulus may have reached its limits which will limit the further rise in commodities. On the Real Estate side, the transitory nature of inflation would keep these assets' rate of return under pressure and support their valuation.
The chart below shows that most of the current inflation is coming from sectors severely hit by the Covid-19 crisis.



Source: CEIC. Goods and services related to Covid-19: Real estates, Second-hand cars, car rentals, airlines tickets, televisions, toys, computers.

Nevertheless, it seems to us that **this reflation theme should continue to persist in the current markets and guide the allocation choices of the coming months,** for two reasons.

The first is merely **psychological** and has to do with the fact that future inflation figures will be high and will most likely remain so until at least the beginning of next year. This has historically had an impact on the investor's psyche.

The second reason concerns **the current uncertainty** and the fact that no one knows precisely how the prices of the services currently reopening will evolve or what the exact consequences of this crisis will be, both in terms of the countries' future development choices (ecological transition, infrastructure, digitalisation, etc.) and their choices concerning the way in which they will be financed (new debt, fiscal rebalancing, etc.). That uncertainty, paired with high inflation figures, should keep guiding the financial markets for at least a few more months.

Asset allocation adjustment

The current environment should lead to changes in asset allocations at least for a while, and this movement is already underway.

In this context, we favour companies that **will benefit from an inflationary environment**, such as banks, which will see their transformation margins increase, or companies that are **rather cyclical (raw materials, energy) and well-positioned within their sector**, which will be able to pass on price increases to their customers. In terms of support, **we favour equities, High-Yield, subordinated financials and emerging debt.** Historically, High-Yield and subordinated debt **have performed very well in phases of reflation accompanied by strong growth**. Good inflation is a positive phenomenon for corporates and high yielding assets.

This phase should also remain very positive for real assets such as real estate, as rental property holdings allow rents to rise during periods of rising inflation, as they are indexed to indices of which inflation is the main component. This concerns real-estate assets held directly, but also indirectly for real-estate held through funds, particularly SCPIs.