Marketing communication – for professional investors – August 2022

Inflation update

By Cedric Scholtes, Co-Head Inflation, Rates Committee Chair

STRUCTURAL INFLATION? OUR TIP: INVEST IN US TIPS

Global inflation dynamics are undergoing a structural adjustment, leaving central banks with a prolonged struggle to bring inflation down to target. We believe the market does not recognize this, setting up an opportunity for investors looking for protection against this risk.

As the risk of higher inflation becoming more entrenched grows, and inflation uncertainty remains high, we believe it has become increasingly important for investors to manage this significant risk.

Strategically, investors could consider incorporating inflation-sensitive asset classes into their allocations to improve a portfolio's resilience. In our view, swapping out nominal bonds for US Treasury inflation-protected securities (TIPS) can offer robust protection over the long term.
Relative to nominal US Treasuries, TIPS now offer long-term value. At 2.48%, 10-year breakeven inflation rates are off their 3.05% peak in April.

Considering the US Federal Reserve's target of 2% inflation, such valuations suggest the market is pricing for the Fed successfully controlling inflation. We believe inflation will remain high and intransigent, making buying inflation protection at current prices is attractive. In other words, inflation protection is now cheap given the upside risks.

Inflation protection is cheap now

As for outright yield, we expect TIPS yields to climb from current levels. We regard 10-year yields of 0.27% as insufficient to bring inflation under control. Rather, we expect the Fed to cause a recession to soften wage pressures and lower commodities prices by enough to turn the momentum in core inflation. We see policy rates rising to at least 4.00%, driving real (inflation-adjusted) yields higher.

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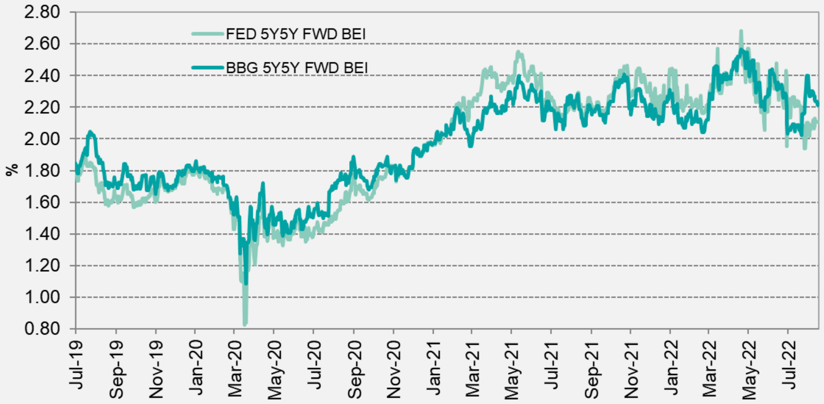
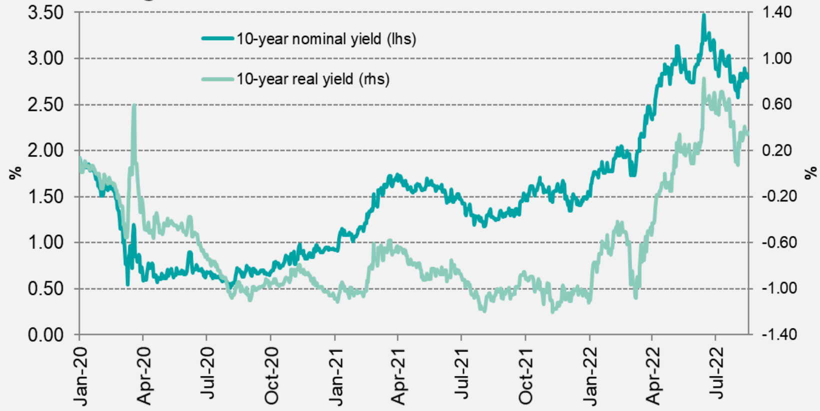
Exhibit 1: Forward rates are off their highs, but US inflation is nowhere near the Fed's target



Source: BNPP AM, Bloomberg, as of 16 August 2022

Exhibit 2: US 10-year yields are not high enough to bring inflation down



Source: BNPP AM, Bloomberg, as of 16 August 2022

The inflation outlook

Until three years ago, the disinflationary forces of trade liberalisation, 'just in time' supply chains, an abundance of commodities and a plentiful supply of labour kept inflation low. The coming decade may bring about much firmer inflation if those structural forces reverse.

Here is our three to five-year outlook:

(a) Inflation (which benefits TIPS via indexation of the notional principal) will descend only slowly towards target amid protectionism, tight commodity markets, a costly sustainable energy transition and a shortage of workers.

(b) We expect TIPS real yields to stabilise at (modestly) higher levels than currently priced as monetary policy will have to do most of the work to contain inflation pressures and US Treasuries will no longer benefit from a global savings glut. Slower trend growth and high debt levels will cap how high real yields can go, without calling debt sustainability into doubt.

Taking a closer look, the pandemic has had persistent effects on **supply chains**. Distribution networks were unable to cope with the surge in demand as consumers switched from services to goods, while rehiring workers proved hard as the economy reopened. Ongoing lockdowns in China led to disruptions to production and distribution. Businesses added to the chaos in supply chains by sourcing more inventories, diversifying suppliers and reshoring production. The war in Ukraine brought a supply shock for energy, metals and agricultural commodities as well as some manufactured goods.

Macroeconomic policy also provided fuel for inflation. The fiscal response to the pandemic was excessive, so much so that household incomes actually *rose*. The Fed cut policy rates to zero and bought USD 4 trillion of Treasuries and mortgage-backed securities, driving real yields negative and fuelling a boom in financial and real estate asset prices. As a result, aggregate demand vastly exceeded supply capacity, prompting a broadening of prices pressures via higher wages and rents.

Housing costs – roughly 40% of the core CPI basket – have reached a high, with primary rent inflation and owners' equivalent rent posting the largest monthly gains since the 1980s. Paradoxically, rate increases can aggravate rent inflation in the near term as rising mortgage rates dissuade homebuilding and force households to rent rather than buy.

As for **labour costs**, with unemployment rate at 3.6% and almost 11 million vacancies, the job market is clearly overheating. Average hourly earnings are up by 5-plus percent – a level incompatible with the Fed's inflation target.

In sum, these supply and demand shocks have produced high, broad and generalised inflation. We believe the risk of a wage-price spiral in the US is significant if the Fed fails to act with sufficient force. Once inflation is sticky, expectations adapt and start to influence price setting, so that companies pass on higher costs and employees seek wage gains to protect purchasing power. Our view, and the Fed's fear, is that inflation expectations are already becoming unmoored.

The risk of a wage-price spiral is significant if the Fed fails to act forcefully

Complicating factors

Tectonic shifts in the global economy are complicating the inflation backdrop. While technological advances and automation will continue to contain inflation through productivity gains, there are reasons to believe other secular forces are turning inflationary.

Demographics – the global workforce is ageing and growing more slowly. A decline in the working age population will result in competition for productive workers as well as higher wages. China's labour force is already shrinking, while in the US, workforce growth has slowed due to fewer births and less immigration. As people age and retire, the ratio of producers versus consumers declines, and global demographics turn inflationary.

Globalisation in reverse – geopolitical considerations and the need to build resilience will encourage the re-shoring of manufacturing, protecting domestic producers from international price competition and raising costs.

Commodities – investment in productive capacity of industrial and energy commodities has fallen short of what is needed to meet demand, in part due to reluctance of lenders to finance polluting industries. Agricultural commodity supply faces greater stress due to climate change.

Green **energy transition** – a rush to build renewable energy production facilities will require costly investments. The supply of renewable energy can also be less predictable. Intermittent fall-backs on limited traditional energy buffers could lead to shortages, resulting in higher and unstable prices.

Inequality & politics – a shortage of labour and a political consensus on the need to fight the growing income gap could drive demands for redistributive fiscal policies and higher wages.

We believe it would be unwise to assume that US inflation will quickly revert to moderation. Against this structural backdrop, and given the ongoing supply disruptions from the Ukraine conflict and China's rolling Covid lockdowns, the Fed may find it as hard to *lower* inflation back to target over the next few years as they used to find it to *raise* inflation to target.

The Fed has 'expeditiously' raised rates to 2.25-2.50% in recent months, but since we expect US core PCE inflation to decline to 3.9% only a year from now, we are factoring in rates of 4.0-4.25%. The risk is that, to engineer a soft landing, the Fed does not slow demand by enough to match tight supply, allowing inflation to become entrenched in household and company behaviour and inflation expectations.

US inflation will not revert to moderation quickly

Investment implications

Over the decade before the pandemic, with structurally low inflation, a typical investor with a mix of fixed income and equity investments did not have to worry much about hedging inflation risks.

High and volatile inflation, however, can reduce profit margins and the need for sharply tighter financial conditions can lead to simultaneous underperformance of equities and fixed income with diversification benefits evaporating as correlations converge to 1.

As said, investors could consider adding inflation-sensitive asset classes to their portfolios to improve its resilience against inflation risks. We believe US TIPS offer long-term value. Buying inflation protection at current prices is attractive. We also think TIPS yields have further to climb.

In the next few years, the costs of 'on-shoring' supply chains and the energy transition will require government budget funding and may influence real yield term premiums.

Given the inflation outlook, we believe a structural allocation to TIPS is advisable. We would buy TIPS on an outright basis as 10-year real yields climb in coming weeks or months and reach 1.00%.

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