The impact Of inflation On markets

21/10/2022

WHITE PAPERS FINANCIERS

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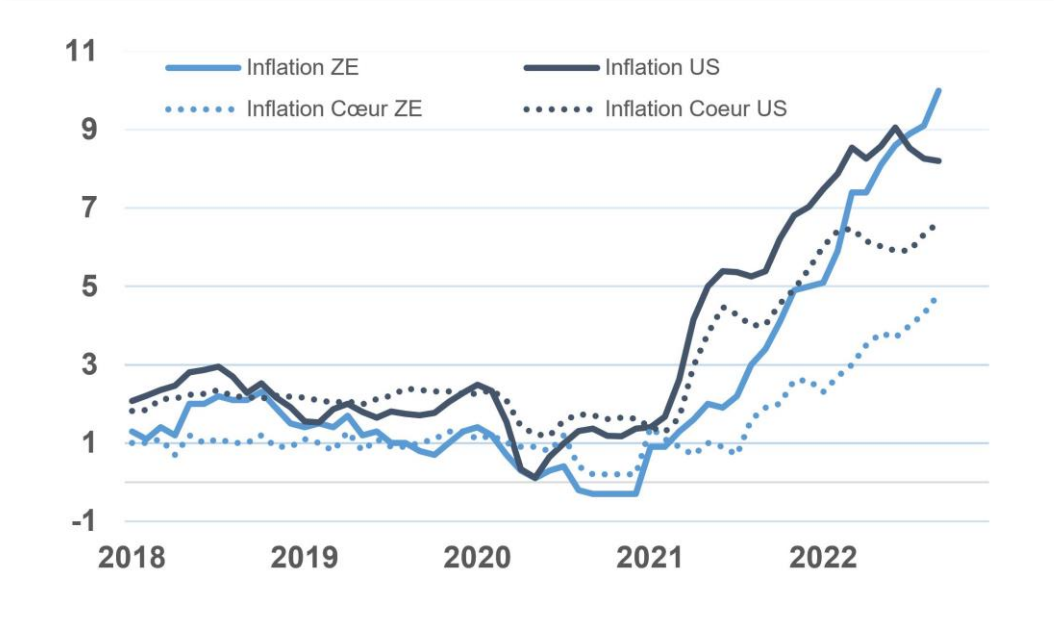
INTRODUCTION

INTRODUCTION

After a decade marked by the absence of inflationary risks, we have been experiencing a sharp acceleration in inflation for more than two years. The Covid crisis had first dealt a blow to this situation by creating strong demand when the economy reopened.

The war in Ukraine caused a major inflationary shock that was added to the previous one, which was linked to the end of the health crisis. While an improvement was underway in supply chains at the beginning of 2022 (restocking, start of normalisation on freight, reduction of delivery delays), this new shock prolonged the sharp rise in 2021 prices and its economic implications by bringing additional disruptions to energy prices, world trade and input prices.

Inflation in the Eurozone and the US



Source: Bloomberg

DECRYPTION INFLATION ON FINANCIAL MARKETS

21/10/2022

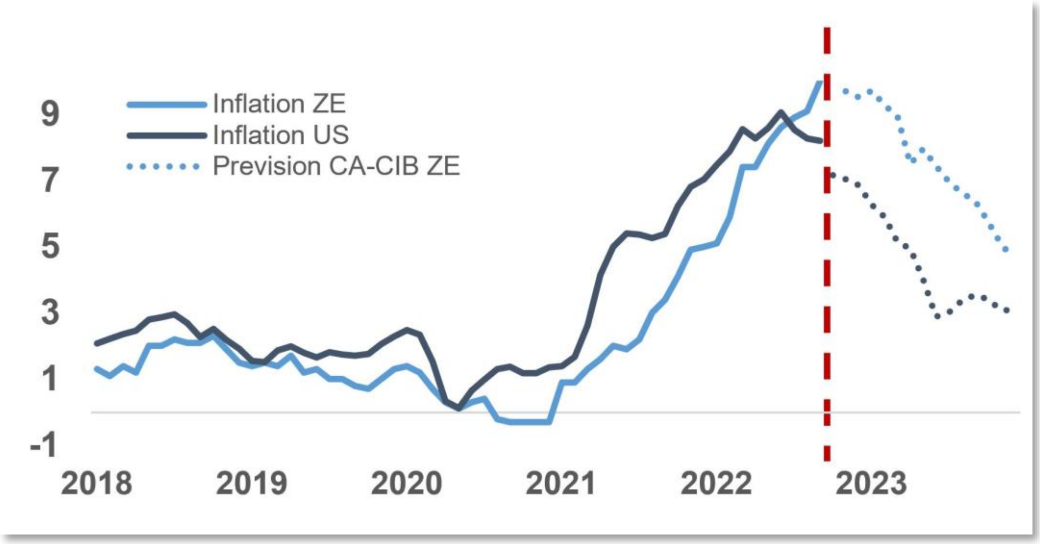
Crédit Mutuel Asset Management

DECRYPTION OF INFLATION ON FINANCIAL MARKETS

SHORT TERM INFLATION ANALYSIS

In this episode, the credibility of Western central banks was particularly affected by their assessment of inflation in 2021. They judged the rapid inflation of 2021 to be ‘transitory’ and then had to admit that they had been wrong, and are thus far behind the curve of monetary tightening. The ECB thus closed its forward guidance last year. At the end of 2021, its exit schedule from its ultra accommodative policy provided for the end of its emergency purchases, then the gradual reduction of purchases made under its regular program until their complete cessation, and only then, a first rate increase. With this sequence, the ECB lost precious months as inflationary pressures strengthened. With its window of fire shrinking, it is now forced to raise rates faster and faster, at a time when the threat of recession and the change of government in Italy are darkening the horizon of the eurozone. The Fed, which hiked rates by 75 basis points twice on 15 June and 21 September, seemed unlikely a few months earlier.

Euro area and US inflation projections



Source: Bloomberg

The situation in the eurozone

Unlike in the United States, where wages and rents are the main causes of inflationary pressures, inflation in Europe is mainly driven by rising costs of living, particularly in energy, food and the prices of goods and services. Services in response to higher input prices.

On the latest figures, we have again seen that inflation in the euro area reached a record level for August while price pressures continue to spread to almost all sectors of the economy. The HICP was up 10.0% year on year in September 2022, from 9.1% in August 2022, 8.9% in July 2022 and 8.6% in June 2022. Inflation has been steadily rising for more than a year, first fueled by strong demand following the reopening of Covid's post pandemic economies with supply problems, then the acceleration of the surge in energy prices this year, as a result of the war in Ukraine.

Even excluding the volatile components of energy and unprocessed food, core inflation remains well above the ECB's 2% target, showing that price increases continue to spread more widely to the economy. Inflation excluding energy and unprocessed food reached 4.8% year on year in September, after 4.5% in August, 4.0% in July 2022 and 3.7% in June 2022. The acceleration in core inflation during the summer was all the more underestimated due to the inclusion in the German services index of the quasi free public transport services (trains, trams, metro, bus) introduced for the summer period (3 months) in Germany and a slight delay in the period of balances in France.

This sharp rise in core inflation continues to be a concern, particularly as it reflects the spread of inflationary pressures to all parts of the economy and not only to the most volatile components. It should also be noted that if the energy component continues to stabilise in recent months (at a rate of around +40% year on year) thanks to the various measures announced by the States to combat the rise in energy prices (tariff shield, reduction of VAT and other measures decided by each European government), the outlook for energy prices could rapidly deteriorate in the event of a worsening of the economic consequences of the conflict in Ukraine (and in particular in the event of a complete breakdown of the supply of Russian gas).

For the coming quarters, energy prices should remain at their current high levels if we do not see a further deterioration of the European energy crisis, while food prices should continue to accelerate as increases in input costs (raw materials, energy, logistics and labor) are passed on to consumers. This should be particularly the case for cereals for which the 2023 harvests are endangered in Ukraine (important cereal producer), but also for fruit and vegetables with significant seasonal shortages for crops coupled with increases in farm operating costs (increase in fertiliser prices, etc.) And difficult weather conditions (drought) that will fully play the effects of ‘second round.’ Agri food manufacturers are also warning of price increases still to come by the end of the year.

In industrial goods, past price increases in energy and logistics costs should continue to pass on to final consumer prices, and this could be amplified by the risks of further lockdowns in China and the depreciation of the euro currency. On the services side, inflation will remain high, especially via the salary component. Indeed, we should see wage increases in the coming months (with in particular the minimum wage increases in France and Germany already applied or to come), even if for the moment they remain contained or limited to certain sectors such as catering in France. We will monitor any acceleration even if the impact on selling prices, and thus inflation, will be highly dependent on the level of competition, corporate margins and the level of rigidity of the labor market (much stronger in the euro area than in the United States), which makes us exclude at this stage any scenario of a loop price wage for the euro area, even in a context of strong social claims.

In this context, total inflation is expected to stabilise at around 10% until the beginning of 2023, before starting to slow down in 2023, mainly due to a negative base effect on the energy component, a start to a decline in food prices, a normalisation of the price of manufactured goods as bottlenecks in production chains subside and the possible impact of a moderate recession on the European economy. The level of uncertainty for H2 2023 and beyond remains extremely high, however, given the possibility of a sharp economic slowdown in 2023 that would significantly impact inflation levels.

Conversely, core inflation could continue to accelerate to 5-6% in the last quarter before returning to a plateau of around 4% until the beginning of 2023.

The situation in the United States

In the United States, although headline inflation peaked in June (+9.1% y/y in June vs. +8.5% in July, +8.3% in August and +8.2% in September), the risk that it will remain at very high levels is significant given the further sequential acceleration of the underlying part observed in recent months. Total inflation should end the year slightly lower at around 7-8% at the end of 2022 before starting a larger slowdown below 3% at the end of 2023.

On the core inflation side (excluding energy and food), after a strong acceleration in recent months, we expect a stabilization of around 6% to 7% year on year until November (we had 5.9% in July 2022, 6.3% in August 2022 and 6.6% in September 2022) due to inflation in services still high (support of the real estate component and positive trend for food, natural gas and food inflation) while durable goods inflation is expected to slow (due to negative base effects). Core inflation is then expected to decelerate sharply in 2023 due to negative durable goods inflation (old and new cars, furniture supplies in particular), partially offset by a positive contribution from services.

For durable goods, after a strong contribution to core inflation in 2021 and early 2022 (driven by the sharp rise in energy and transport prices and the significant demand linked to the reopening of the US economy, the wealth effect and the fiscal stimulus), these have negative base effects that will accelerate in the second half of the year. This is particularly the case for the used car component (5% of the core inflation basket) which had accelerated sharply from H2 2021 (with year on year growth of around 40% until February 2022) due to several factors (shortage of semiconductors, consumer demand inflated by the distribution of cheques to US taxpayers, postponement of consumption that had not been possible during lockdowns). However, the price of old cars should continue to decelerate in the coming months, probably with a negative contribution in 2023, helped by expected negative base effects (as a result of the acceleration phases of 2021 and 2022).

In 2022, services took over from the acceleration of inflation as a whole, and not just rents, unlike what had happened in 2021 in connection with reopening, resilient demand and rising wages and input costs. On the real estate side, the sharp rise in real estate prices (+13.5% yoy to June 2022 after a 25% rise in 2021) is expected to slow in the coming months due to the sharp rise in mortgage rates, the decline in disposable income (reduced by high inflation), and a decline in household confidence. However, it will remain supported by strong US growth and high input price inflation (labor, commodities).

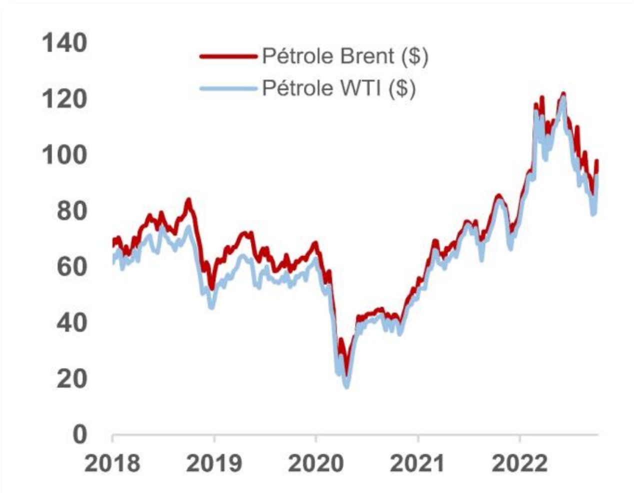
Finally, as a reminder, the rent and equivalent rent component (OER) generally lags by around 15 months, which suggests that this component will continue to rise until the end of 2022 and the beginning of 2023 at around 6-7%.

Indicators to follow in the coming months

Oil prices (Brent and WTI)

Even before the introduction of the European embargo, Russian oil had already become very difficult to access the international market and European decisions, including that of prohibiting the insurance of Russian cargo, should result in an additional reduction in exports.
Even taking into account the appetite of India, Saudi Arabia and China for Russian oil at reduced prices (which sometimes resells it to countries applying the Russian embargo), much of it will disappear permanently from the international market.

Oil prices

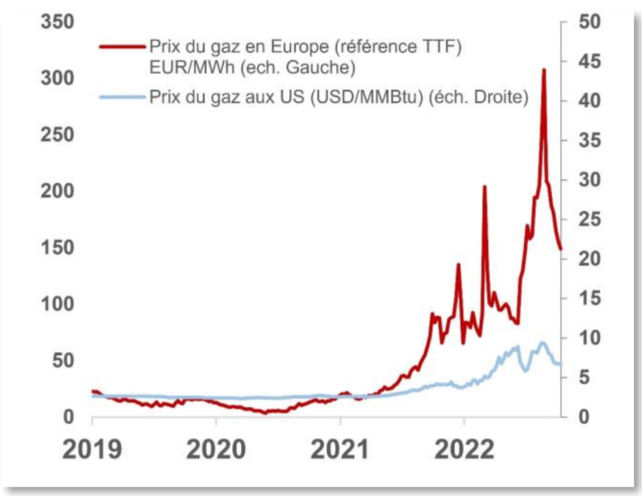


Source: Bloomberg

European and American gas prices

While the price of European gas had fallen in recent months, thanks to the influx of US liquefied natural gas, the momentum has suddenly reversed due to the prolonged shutdown (until the end of the year) of a plant that accounts for nearly 20% of LNG production in the United States.
Vladimir Putin seems to have seized this opportunity to increase pressure on Europe by drastically reducing gas flows, officially due to technical incidents, but more likely to force Europeans to negotiate a lifting of sanctions on his country.

Gas prices



Source: Bloomberg

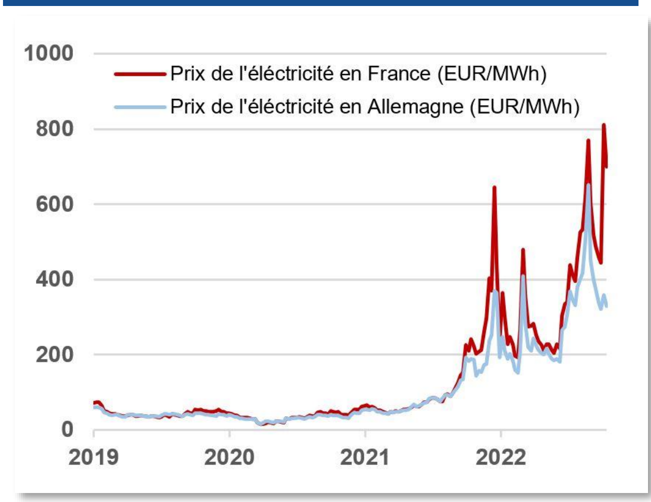
The risk of a total embargo by Russia is getting closer and will force the market to remain extremely tight, which will keep prices at very high levels. As a rough estimate, an increase of EUR10/MWh implies a 1st order impact of a 25 bp increase in the total HICP inflation figure of the euro area through the natural gas and electricity components of the CPI. This relationship depends on the intensity of the response of national governments (a price freeze making the sensitivity nil) and the specificities of each country (specific regulations, different tax regime, frequency of price revision, etc.).

More recently, despite the relapse in oil prices amid renewed fears of lower demand, and hopes for an agreement on Iranian nuclear power between the European Union, the United States and Iran, the price of gas in Europe is end August at its peak last March (close to €230/MWh) due to the rebuilding of gas stocks for next winter by the states, the sharp reduction in Russian gas exports and adverse weather conditions. This increase therefore threatens the relapse in energy prices, especially as European economies have tended to strengthen the role of gas in their energy mix over the years.

Electricity prices in Europe

Imbalances in the oil and gas market are expected to result in tensions in the electricity market, with an even greater impact as other energy sources will not compensate for this deficit. Nuclear generation is in fact highly disrupted in France (it will be at a low for more than ten years according to Edf forecasts) while intermittent renewable energies and climatic hazards fuel uncertainty as to their availability. These elements will fuel sustainably higher electricity prices.

Electricity prices



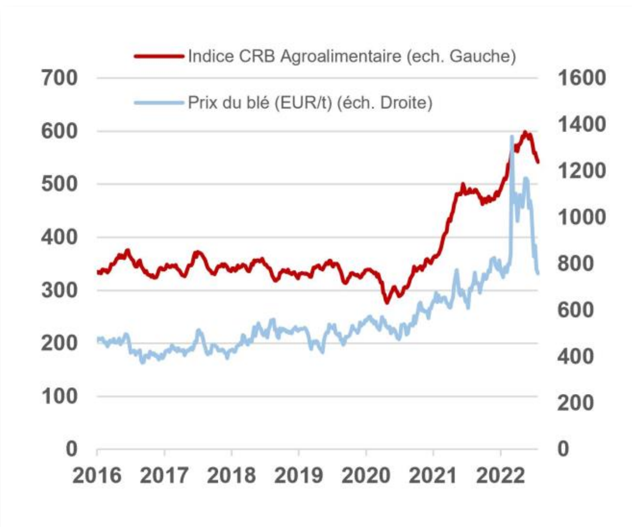
Source: Bloomberg

What are the risks of inflation on prices?

Risks on food prices (consequences of the conflict in Ukraine)

Geopolitical tensions with Russia continue to maintain the upward trend in food prices while V. Putin still refuses to allow Ukrainian grain exports, which are crucial for emerging countries in particular. Fears of shortages are leading several countries to ban food exports (wheat in India, chicken in Malaysia, palm oil in Indonesia). The geopolitical context and the consequences of climate change will continue to fuel the upward momentum on food prices with a growing risk of social crises.

Food price risks



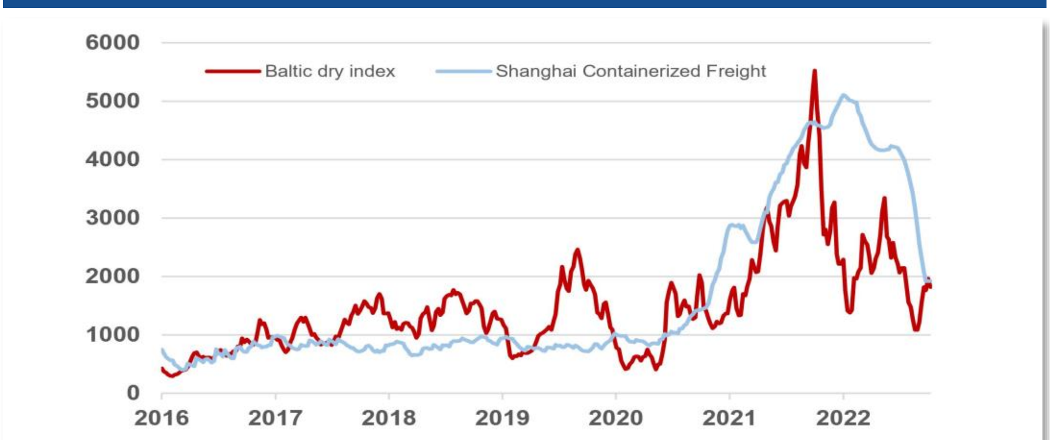
Source: Bloomberg

Risks on the price of goods (plant closures, difficulties in supplying inputs, logistics problems and freight)

Lockdowns in China and the war in Ukraine have slowed the improvement in supply chains. But the trend seems to remain positive as demand deteriorates and companies rebuild precautionary stocks. A normalisation of supply chains is still in sight, good news for the price of goods which should begin to regulate.

The risk of a complete breakdown in the supply of Russian gas to Europe will force European economies to reduce their natural gas consumption by around 15% with potentially a strong contribution from so called non essential sectors such as automobiles or other durable goods, which could lead to further disruption and disruption of production chains. Other types of durable goods that could be affected are bicycles, furniture, home furnishings, etc.

Risks on the price of goods



Source: Bloomberg

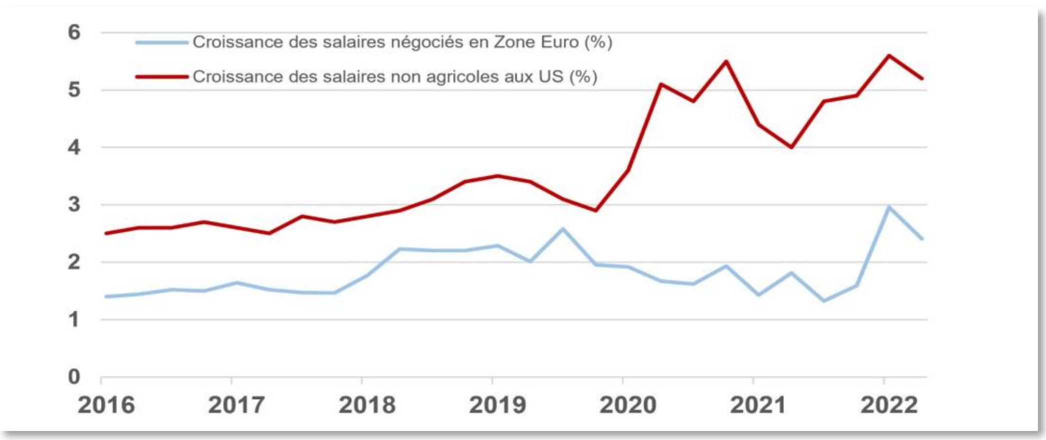
Risks on wage developments (lack of labour, social claims)

In Germany, the metallurgical trade union IG Metall raised its demands for wage increases from 7% to 8% for the new year. The minimum wage increased by 6.5% on 1 July before a further revaluation of 15% on 1 October, in line with the coalition's promises to raise it from 9 to euros12 per hour. But beyond the particular case of Germany, some economists believe that wage inflation could assert itself in the euro zone, as it did in the United States, but with corporate margins much higher in the United States.

While the influence of the price environment on wages has been slow to manifest itself, relative to what has been observed in other economies, there is little doubt that the movement is now underway. Wage revaluations and minimas are imparable and often encouraged by policies to lessen the social shock of rising prices. This is also the case in France. While inflation can not yet be explained by wages, their rise tends to maintain it. And this could be sustainable, linked to the structure of the unit wage (the wage per employee minus the productivity gain, knowing that the unit wage cost evolves more or less in line with inflation Underlying).
The French example, with an employment rate at its highest level and an unemployment rate at its all time low, also tends to create favourable conditions for sustainable wage inflation. The expected strike movements and wage demands could lead to an improvement in the coming months: It is clear from business climate surveys that all components related to the activity (orders, production, etc.) But not on the employment component, which remains above its long term averages, which should be reflected in wages as well. For now, it seems that bonuses and bonuses have contributed significantly to wage increases to retain employees in a tight labour market environment. But some believe that this could change, theoretically with effects on corporate profit margins, or on inflation if companies manage to pass on these increases in prices.

The chart opposite shows the main wage inflation indicators monitored by the ECB (wages traded in the euro zone with a one quarter lag) and by the FED (hourly wage growth resulting from the monthly report on US non agricultural jobs, NFP).

Risks on wage developments



Source: Bloomberg

Risks on changes in the exchange rate (euro/dollar exchange rate)

With a EUR/USD exchange rate close to 1, the upward impact on European inflation is significant, although it should be recalled that a large part of the euro area's trade flows take place within it and is therefore not affected by fluctuations in the exchange rate. According to the ECB, the transmission of a 10% drop in the euro would only have a cumulative effect of around 60 bp bullish on the HICP figure in the euro area with 30 bp in year 1 through the direct impact on the price of energy (often denominated in USD) and 30 bp in year 2 due to durable goods and services. This impact therefore seems small compared to the movements that can be expected on the energy price side.

INFLATION TRENDS AND CHALLENGES OVER THE MEDIUM TERM

Over the medium term, we expect inflation to return to levels more in line with central bank targets, but higher than in the last decade for a number of reasons. First, the profound changes in the organization of the world economies following the pandemic crisis, then the conflict in Ukraine with many relocation movements should contribute to fuel inflation on both sides of the Atlantic.

This dynamic is reinforced by the recent willingness of European states to strengthen their military defense and independence in strategic sectors (energy, food, technology) with a sharp acceleration of public spending in these areas, which will fuel inflation. On the other hand, the cost of the ecological transition, where tens of thousands of billions will have to be invested to develop energy sources and cleaner production, will be partly financed by higher energy prices.

For example, the European Union recently announced its intention to significantly accelerate the schedule of investments in renewable energy and liquefied natural gas terminals to reduce its energy dependence on Russia. It will also generate higher demand for certain metals (cobalt, lithium, nickel, etc.) And a lack of additional labour in some industries, again with inflationary consequences.

SHOULD WE CHOOSE TO FIGHT INFLATION OR INVEST IN THE CLIMATE TRANSITION?

21/10/2022

SHOULD WE CHOOSE TO FIGHT INFLATION OR INVEST IN THE CLIMATE TRANSITION?

Largely as a result of the growth of the money supply in recent years, central bankers having had to face a first global financial crisis in the early 2000's, then face the economic consequences of the health crisis and finally revive the economic engine, inflation has been packed with the recovery of world trade and the problems of corporate supply. The unavailability of certain products has increased with the armed conflict in Ukraine, causing a new price shock, particularly on food raw materials and especially energy (embargo and sanctions on the program of the various belligerents).
Until we know whether the new monetary policies pursued by the world's central banks will be effective in curbing inflation and trying to return, in the long term, to an increase of less than 2% per year, the urgent economic and energy measures taken by the countries are not without impact on sustainability and the climate and social transition.

INFLATION HAS MULTIPLE FACES...

On the one hand, ESG considerations, so long defended yesterday, are becoming obsolete in the face of the urgency of the energy crisis and the costs generated by it.

- Europe's desire to rapidly reduce its dependence on Russian gas is largely based, at least in the short term, on an increase in imports of liquefied natural gas. Thus, almost all US LNG exports, whose value chain is highly CO2 emitting and destructive of biodiversity, are now delivered to Europe.

- Germany, which has a hyperinflation in gas costs of 100 to 200 Bn €, authorised the reopening of 27 coal fired power plants until March 2024, i.e. around 10 GW, bringing the share of coal to one third of the electricity mix (24% in 2020).

- In the Netherlands, the government has authorized the full capacity use of coal fired power plants, compared to a maximum of 35% previously, and in France, a power plant closed in March 2022 will be reopened for next winter. Such measures are also envisaged or even implemented in Austria, Italy and Bulgaria. Greece will double its coal fired power generation over the next two years and postpone the coal exit date from 2023 to 2028.

On the other hand, having become sensitive to energy security, a number of stakeholders are questioning the urgency of investing in energy innovation and the virtues of independence.

In the United States, the landmark Inflation Reduction Act (IRA) enacted on 16 August 2022 is a good example. Among a host of other topics, it includes provisions on climate change mitigation, clean energy and energy innovation, including
369 billion US dollars are specifically earmarked for these initiatives. These measures aim to reduce US greenhouse gas emissions by 40% by 2030, compared to 2005 levels, and include a wide variety of incentives for clean energy and tax credits for certain activities, including electric vehicles and solar panels.

The energy transition is winning as tax incentives on solar and wind power are favoured with accelerated depreciation. Nuclear energy and electric vehicles, local manufacturing, offshoring and the transfer of supply chains to countries with free trade agreements with the United States alone will be supported by domestic subsidies... This is particularly about ‘stimulating competition in the field of clean technologies.’
If the oil and gas industry retains its prerequisite as a privileged exporter, under the guise of ‘promoting domestic jobs’ (weight of lobbies), federal legislation will be relaxed regarding the exploration, production and construction of pipelines, if the development of renewable energies, carbon capture and storage, hydrogen and biofuels are favored.
This guidance suggests that IRA investments will create nearly 10 million jobs over the next decade. To fund the program, the US government expects a minimum tax rate of 15% for companies with profits of more than $ 1 billion.

It remains to be seen whether the IRA will reduce rising prices and how much it will reduce the increase in anthropogenic carbon dioxide emissions...

On the old continent, the European Commission has accelerated its hydrogen plan. The Hy2Tech project provides for public financing of up to € 5.4 billion, which can mobilise an additional € 8.8 billion in private investments. 35 companies in the Member States will participate in 41 value chain projects (low carbon hydrogen production, fuel cells, storage transport distribution, uses including in particular mobility).
All in all, these responses on the energy supply side will probably not be enough in the face of inflation. The transition to a sustainable energy system will require lower demand. The IEA (International Energy Agency) recommends an immediate reduction in gas consumption and the European Union has published a very ambitious plan that requires each country to do ‘everything possible’ to reduce its gas consumption by at least 15% between August 2022 and March 2023.

But the combination, on the one hand, of such a destruction of demand leading to restrictions in the coming winters and, on the other hand, of hyperinflation of the energy bill, risks fuelling a deteriorated social context. Already, thousands of British people refuse to pay their electricity and gas bills and more than 100,000 people have signed the ‘don't pay UK’ petition... A civil disobedience movement that could grow in Europe.

In conclusion, the fight against hyperinflation and compliance with climate transition commitments: A balance that is at least uncertain.

WHAT ASSET ALLOCATION IN AN INFLATIONARY ENVIRONMENT?

Crédit Mutuel Asset Management

21/10/2022

WHAT ASSET ALLOCATION IN AN INFLATIONARY ENVIRONMENT?

Asset allocation is a key component of portfolio management and its importance increases in times of uncertainty. Thus, in times of market volatility, investors tend to increase their exposure to 'safe haven assets,' such as gold. Faced with an era of rising rates, they first seek to avoid fixed income assets to return to them in a second step, once the rise in yields is well underway.

At a time when central banks are aggressively raising policy rates, asset prices are falling and a recession seems inevitable, asset allocation is more important than ever. Indeed, in recent years, the bond and equity markets have been mainly led by the central banks, which, in fact, over this period of time, the two markets, which, in normal situations, follow their own trajectories, have often been correlated, which complicates the allocation, because it requires looking for other uncorrelated assets. This exercise is even more important in times of high inflation.

WHAT IS THE IMPACT ON PORTFOLIOS OF A HIGH INFLATION REGIME?

The effect of high inflation on the allocation is an increase in the profitability of real assets (commodities, real estate, infrastructure, inflation linked bonds and physical precious metals). In the event of high inflation, equities and bonds show negative real returns while real assets perform much better. It should be noted that investments in commodities have a much higher nominal and real return in an inflation regime than in a low inflation regime.

WHAT ARE THE EFFECTS OF HIGH INFLATION ON THE ASSET CLASSES TO WHICH INVESTORS ARE MOST EXPOSED (EQUITIES AND BONDS) AND HOW HAVE WE MANAGED THESE TWO ASSET CLASSES?

Bonds

As inflation expectations rise, bonds incorporate this rise to provide investors with the return they demand. This shift to higher yields is very bad for bond profitability because of the decline in profitability that accompanies the rise in rates. In our allocation, we have therefore tended to reduce the weight of US and European bonds in recent months. In addition, to compensate for the fall in the prices of sovereign bonds in the developed world, we sought yield in the emerging world, and more particularly in China, whose bonds benefit from the Chinese key rate cuts.

Equities

Companies are affected by rising input prices, but not all have the same adaptability.
Low Pricing Power companies are vulnerable to revenue, margins and earnings. As they cannot pass on their costs to their clients, they will be less attractive and therefore cheaper. For the latter, there is a risk on the balance sheet that the markets will appreciate according to the economic cycle.
In these circumstances, we have chosen equity funds of companies that are strong both on their balance sheet and on their pricing power.

HOW DID WE USE INFLATION AND OTHER ASSETS NAMES?

Inflation linked bonds are an asset class that benefits from inflation and can protect investors during periods of high inflation. Eurozone and US inflation linked bonds were used in our allocation during the first two quarters and will continue to be used in the second half of the year.
We also invested in precious metals through gold, precious metals and oil funds.

Finally, we used currencies (which are not considered as an asset class, but which are part of our allocations) and particularly ‘safe haven’ currencies such as the yen, the Swiss franc and especially and always the dollar. Of these 3 currencies, we opted for the US dollar, which at the end of August appreciated by 13.1% against the euro.

THE IMPACT OF INFLATION ON THE SHARES, FOCUS ON SECTORS

Crédit Mutuel Asset Management

21/10/2022

THE IMPACT OF INFLATION ON EQUITIES, FOCUS ON SECTORS

The impact of inflation on equities is complex. Indeed, the sector of activity, the positioning in the economic cycle and in the value chain are all criteria that must be analyzed to position themselves. Particular attention must also be paid to the life cycle of products and services in order to provide a fair analysis. All these points demonstrate the importance of rigorous stock picking. Nevertheless, some major principles are emerging.

During periods of inflation, corporate margins may be subject to the following pressures to varying degrees:

- Energy costs
- Raw material costs as currently (supply problems)
- Wage inflation
- Higher financing costs
- The appreciation of the US dollar

We know that companies with the ability to pass on higher costs in their selling prices, pricing power, are holding up better. However, the degree of dependence on the economic cycle is key. A company like ASML, for example, a leader in semiconductors, has only included in its contracts a price adjustment up to 2/3% of inflation. A luxury company like Lvmh will be able to adapt with greater flexibility. The majority of companies talk about passing on inflation in their prices, even if each sector reacts differently.

While half yearly publications have shown the very good price elasticity of certain sectors, it is clear that after certain inflation thresholds, agile adaptations will be rarer.

Some examples of impacts of strategic adjustments to price increases for companies:

- Deferral of investment decisions
- Prudence in forecasts
- Difficulty recruiting
- Cost cutting expectations (historically advertising, travel, software and services are the primary spending items)

SECTORS POTENTIALLY MOST IMPACTED

Industry

In this vast and heterogeneous sector, where sensitivity to the economic cycle is obvious, wages account for 24% of sales and 29% of costs on average.
With second round wage inflation high as in Germany where the IG Metall union negotiated a wage increase of +5% to +8% for the industrial sector, the impact is significant.
Fortunately, some companies have cost linked service contracts for maintenance operations such as Siemens, Kone, Schindler, SKF, GEA. As these price revisions are annual, forecasts of actual financial impacts are often a source of surprise for markets.
Let us not forget to mention also the possible imbalance between the location of costs and the area in which revenue is generated. For example, 70% of GEA's employees are based in Europe, where the company generates only 52% of its sales. Inflation is not evenly distributed across Europe and this also explains the impacts that are difficult to generalize.

Despite the relative pricing power of the players least sensitive to the sector's economic cycle, inflation is impacting the margins of industry stocks.

Utilities

Given the long duration of the sector's assets, such as long term, highly regulated energy supply contracts, the sector underperformed in periods of inflation and growth.
Inflation is putting pressure on interest rates. The average cost of capital increases for projects, which is reflected in the years of the concession until its completion. Without renegotiating the initial conditions, the value of assets measured by their ability to generate cash flow is reduced by the same amount.
The most negatively impacted stocks are those that manage a country's infrastructure: Gas pipelines and electricity networks with a lifespan of more than 25-30 years.
In some countries, inflation has shifted into asset returns (as in Italy).
On the other hand, in a context of inflation and recession, this sector becomes defensive, as it is not subject to falling demand. There is a significant degree of advancement in the cycle and the relative characteristic of the rest of the equity market of these companies that offer high and rather stable dividend yields.
Similarly, the players in renewable energy and gas or electricity infrastructure remain protected sectors and defensive investments, safe haven companies that are expensive to Anglo Saxon investors. The greatest risk then becomes the risk of state intervention, through the introduction of additional taxes. Renewable energy players are now favoured because they benefit on average from high electricity prices. However, some have already sold their production in advance at a fixed price.

Let's remember that renewable projects remain rare and demand is growing strongly, which militates in favor of supply... The energy transition is a major challenge, costly in the short term in investments, but indispensable to the long term balance, which is valued in our market approaches.

Real Estate

Historically, during periods of rising interest rates, real estate has suffered. According to specialist analysts, in times of high inflation and low growth (top right), only the property sector exposed to healthcare businesses (clinics, retirement homes, etc.) works well.

Estimates for rental growth depend on owner resistance to the cycle. This means analysing the market by market. There is also the regulatory framework by country, often in support of recovery policies. For Germany, rents should therefore continue to rise, as the framework coincides with a structural need for housing.

What companies say about rents and cost inflation
During our discussions with market players (Gecina, LEG, Vonovia, WDP, CTP, Segro, Aroundtown, etc.), we understand that these companies are able to withstand inflation. Property companies explain that the rise is expected to be lower in the second half of the year. ICADE tells us That above 3%, however, it is difficult to reimpact all inflation.

SECTORS THAT CAN BENEFIT FROM INFLATION

The Bank

Overall, inflation with moderate and steady GDP growth is the most favourable environment for banks. The link with the stage of progress in the economic cycle remains strong.

Thus, in the 70's, banks generally outperformed during periods of inflation, excluding periods of recession. High interest rates improve margins and growth increases loan volumes.
Banks are exposed to cost inflation mainly through wages, so leverage is significant. Today, European banks are well capitalised and are continuing to streamline their networks, maintaining a proximity advantage over neo banks. Excluding the resurgence of default rates, they therefore seem to be well positioned while keeping in mind the temptations of regulators to regulate the price of services or to introduce exceptional taxes.

The Oil Sector

Demand for hydrocarbons remains unelastic, and the drop in investment since 2014 has allowed for real financial discipline on the part of these players.
In the current environment of a significant rise in oil prices, the sector outperformed. Cost inflation has a marginal impact on profitability and slightly on demand due to recession fears. Their debt is close to zero for some today and should cancel at the end of 2023 for others.
Cash flow generation after investments is on average over 5% per barrel at $50 and would rise to nearly 20% per barrel at $100! In this sector, the European authorities are considering exceptional taxes, the 'Windfall taxes' discussed in Brussels and the application of which remains to be specified.

Construction & Concessions

The ability to cope with inflation varies greatly depending on the segment:
- Motorway concessions and construction are the best positioned (Vinci and Eiffage)
- Airports are likely to suffer more from rising rates and will find it harder to offset cost inflation (AENA)

We distinguish:

Motorway concessions
Motorway concessions are the most attractive activities in an inflationary environment: The tariff increase is contractually indexed to inflation and cost inflation, which represents only 25% of revenues, should remain moderate. With a gross operating margin of nearly 75%, the weight of expenses is limited for motorway concessions.

Airport groups
Regulation is key for this sector.
The significant increase in costs, depending on the cost structure (raw materials 15%, wages 30-40%, energy 2-6%), the hedging strategy and the area of operation. In addition to general inflation, there is a risk of rising wages and recruitment difficulties.

One example: AENA. 70% of revenues is regulated, so the impact of inflation through tariff increases is very limited, which undermines margins. Currently, for 6% of inflation, it is estimated that -10% in gross operating margin on a constant traffic basis. In addition, the energy bill has grown exponentially since 2019, mainly electricity, and no hedging strategy...
However, at Vinci Airports, the main airports ANA, Gatwick and Brazil benefit from directly inflation linked tariffs.

Construction
Hedging strategies or contract clauses allow them to make the increases... for the moment the groups maintain their forecasts. 'No impact on margins' according to Vinci... With regard to Bouygues, the discourse is more cautious, especially on Colas.

While Bouygues and Vinci are reassuring about volume dynamics and demand, which is not falling, caution remains shared on the residential construction part. Prices will not adjust, as households do not have the capacity to finance an increase... This is in addition to the difficulty of obtaining building permits.

Insurance

Reinsurance: It is more difficult to pass price increases over insurers because there are few barriers to entering reinsurance.

Car and home insurance: The sector adjusts its prices each year and the claim is compensated within 6 to 12 months. This therefore makes it possible to offset the cost of repairs and the rise in wages.
This year, car and home premiums increased by 2% due to strong competition between the players and costs increased from +5 to +6%.
Corporate and speciality premiums have risen sharply since the Covid due to a catch up effect on claims accumulated before and the sharp rise in claims (repeated natural disasters).

Life insurance and personal risk insurance are quite immune.

The rise in rates is rather positive with reinvestments at higher rates for new premiums. This impacts new production (between 5% and 15% to be reinvested per year depending on the segment), which is diluted in terms of balance sheet mass.
The current rise in interest rates results in +3%.
In the end, there is little impact of the rise in rates on the balance sheet where management is cautious in buy and hold backed by liabilities.

Solvency ratio: The rise in rates is generally positive, but a widening of bond spreads is unfavorable.

Consumer sectors

Food/Beverages

The fear is that the combination of tighter consumer incomes, further inflation induced price increases and recession fears will lead consumers to abandon major brands in favor of cheaper alternatives and brands. Distributors. This is the principle of ‘downtrading’ not observed to date. For example, Unilever announces a 10% rise in prices for a 2% drop in volumes). To be followed over time.
There is still a risk of a deterioration in consumption, although companies have indicated that price elasticity is below historical levels.

Consumer Discretionary

- Luxury: Pricing power. The strategy of annual or one off growth, like Lvmh this year, with +8/9% in the upscale segment, +3/4% in the upscale segment, while Hermès spends +2/3% every year.
- The material cost effect in the selling price is very diluted. And customers are not very price sensitive.
- Household consumption: L'Oréal, Reckitt have a strong pricing power. Even Unilever already mentioned. P & G in the United States saw a 8% rise in prices, leading to only a 1% fall in volume. But this did not offset the price of commodities (450 bp impact on the margin).
- Hotels/Leisure: Edenred, with its specific interest rate sensitive business, appears to be the big winner.

Automotive

- Rather positive for manufacturers, who are increasing their prices, in a context of shortage of models and waiting list situation.
- Auto parts manufacturers have less pricing power: There are indexation clauses but activated with a delayed effect and only on commodity inflation. In other words, this does not include the effects of wage inflation, logistical problems, etc.

Technology & Media

Semiconductors

- High inflation began in 2021, linked to supply chain disruptions and underinvestment during the Covid, followed by a strong rebound in demand. The sector was impacted upstream of the inflation cycle.
- For most seedlings (diversified chipmakers, equipment manufacturers, etc.), costs exposed to inflation represent 60-80% of the cost of sales. These include materials, transportation, energy costs, and wage inflation, particularly in R & D, etc.
- They spend price increases to offset inflation. It is estimated that 5 to 20% higher costs can be offset by a price increase of 3 to 12%. For example, TSMC announced a 6% price increase in June from 2023. However, not all chip manufacturers are equal. Memory price declines over the past few weeks seem linked to lower consumer demand (smartphones/PCs) and better availability. On the other hand, the rise in average prices of Semiconductors continue for all fleas in shortage, after years of deflationary trend, such as seedlings for the automotive/industrial industry. Indeed, these components only account for 1 to 2% of the costs related to selling prices on the final product, but are essential for new technologies (xEV, ADAS).

Software and IT services: Wage inflation

- Personnel costs represent the majority of operating costs for software and services (softwares/IT services).
- Salary inflation for new software engineers is +10-20% compared to 12-18 months ago, depending on the level of expertise.
- Margins remain under control through both age pyramid management and invoicing given demand and by reducing discounts.
- For service companies, the use of offshore resources.
- Finally, the sector is belatedly affected by the economic cycle, it is called ‘late cyclical,’ with recurring services and contracts of at least 12 months.
- Finally, a strong dollar is usually positive for the sector in general.

Payments sector

Payment companies tend to benefit from inflation as they take a variable percentage on payments made (in the acquiring part), whose average ticket increases, provided that inflation does not significantly slow down household consumption.

Even if a recession looms, payment companies' revenues are not expected to fall sharply. Inflation and the growing penetration of digital payments (structurally close to +10%) are driving activity. As a reminder, in 2020, the decline in activity was only a few points while everything was closed.

In times of difficulty in purchasing power, the trend is also towards a multiplication of small purchases vs. large purchases at once (e.g. petrol): In the processing part, there is a gain on the fixed fee: Taken twice if purchases are made twice.

GOLD SECTOR

On the gold side: A safe haven role that once again played. The rise in long term rates led to selling flows on Gold ETFs.

On the corporate side :
Gold companies suffered from cost pressures, as did most sectors: Energy bill, labour costs, supply costs and raw materials (mainly reagents) needed for metal processing such as the shortage of cyanide.
The impact would be estimated at between 5 and 10% based on the cost of mining companies.

In conclusion, inflation is not the only factor to consider. Companies will behave differently in response to different scenarios on the peak of inflation and its interest rate and monetary policy consequences, not to mention the impact on currencies.
What we do not control is the weight of the geopolitical context (Ukraine, China, elections), but also health.

THE IMPACT OF INFLATION ON THE BOND MARKET, FOCUS ON INFLATION LINKED SECURITIES

Crédit Mutuel Asset Management

21/10/2022

THE IMPACT OF INFLATION ON THE BOND MARKET, FOCUS ON INFLATION LINKED

In the euro area, the latest statistics have confirmed that inflationary pressures related to energy are continuing and that those more sustainable related to wages (therefore in services) are gradually strengthening. With gas and therefore electricity prices going through the summer, the risks to inflation are clearly rising for the coming months, and recent statements by ECB members place a heavy emphasis on fears of the lasting consequences of high inflation for so long.

The context therefore justifies a large scale action on the part of the ECB, which is likely to continue to raise both short and long sovereign rates to higher levels. At the end of August, German 10 year yields regained their levels at the end of June, wiping out much of the fall in the summer (+80 bp since the low) amid fears of recession and central banks that would ‘backtrack’ their monetary tightening in 2023. We do not think this is the case in a context where inflationary pressures seem to us to be sustainable and while the withdrawal of ‘tariff shields’ and other state aid, aimed at containing prices currently, will be gradual in 2023 and will limit the ability to relapse prices (without preventing it).

In this context, we continue to be slightly positioned
We remain underweight in our fixed income portfolios and maintain exposure to pockets of inflation linked bonds.

Within the indexed bond buckets, in terms of maturity, we maintain a preference for short and intermediate 2 to 5 year inflation linked bonds, which have been and will be supported by a very strong indexation to inflation due to the sequential acceleration from one month to the next of CPI in the euro zone which should continue at least until the end of the year and continue to offer a significant carry effect until Q1 2023 at least (due to the lag of 2 to 3 months in the indexing mechanism). Bonds indexed to short and intermediate maturities also seem to us the most likely to benefit from the continued energy shock in the euro zone in the coming years. They should also be less sensitive to the continued tightening of the ECB's monetary policy in the coming months compared to the maturities of 10 years and beyond, which are the indicators followed by the Central Bank to measure inflation expectations in the market and which are directly affected by the tightening of monetary policy.

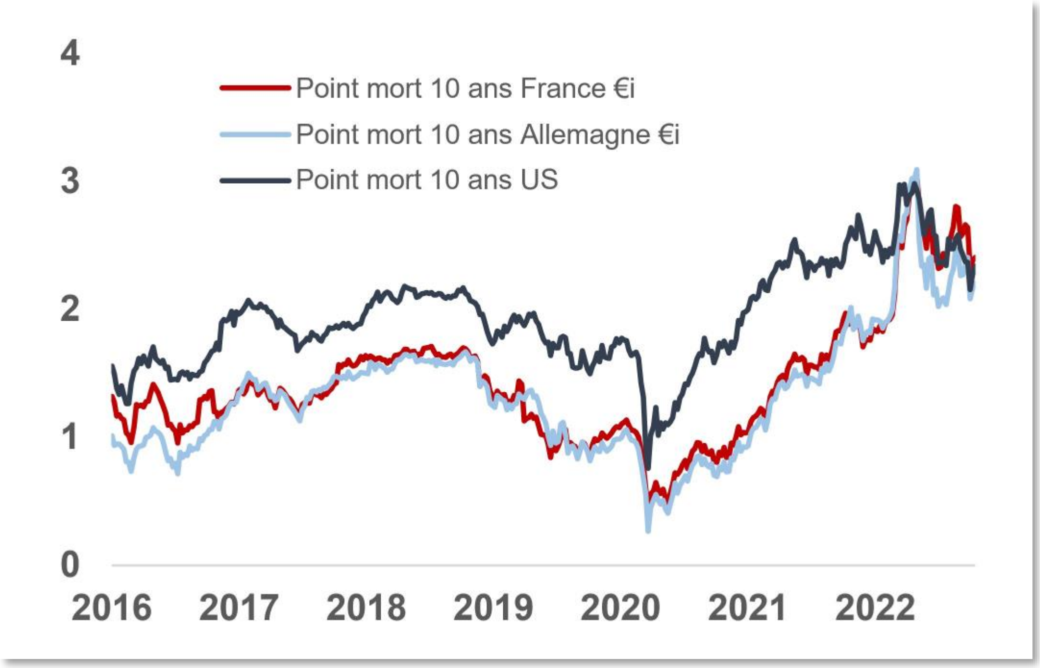
In terms of indexation, we have been marking since the end of 2021 a Underexposure to French inflation linked OATs in favour of European inflation linked OATs given the importance of tax measures in France, which have strongly contained the size of the French CPI.

In the United States, the peak in inflation should be behind us, even if the slowdown in inflation will be very slow. We believe that upside risks to inflation are lower and better managed than in the eurozone. In this context, we are neutral on US inflation linked bonds (TIPS).

INFLATION EXPECTATIONS IN THE MARKET THROUGH INDEXED BONDS

After a period of strong growth fueled by the publication of inflation figures that systematically exceeded investors' expectations, European and US breakeven rates have started a significant correction phase since June, as investors remain focused on fears of economic recession despite inflation publications that are still expected to accelerate in the coming months with a peak before the end of 2022. High inflation figures can even play a negative loop for breakevens as they fuel investors' fears of faster monetary tightening and a higher risk of recession.

Expectations



Source: Bloomberg

The inflexion point for a rebound in breakeven rates could materialise later in 2022 when central banks change their strategy if they consider the inflation risk to be controlled and decide to slow down or even stop the tightening of their monetary policy in order to less fight against inflation and more preserve growth (or at least limit the risks of recession).

APPENDIX
INFLATION GLOSSARY: DEFINITIONS, MEASURES AND COMPONENTS

Crédit Mutuel Asset Management

21/10/2022

APPENDIX

INFLATION LEXICON:
DEFINITIONS, MEASURES AND COMPONENTS

REMINDER OF THE DEFINITION OF INFLATION IN THE SENSE OF STATISTICAL AGENCIES

Inflation is the loss of the currency's purchasing power, resulting in a general and lasting increase in prices (INSEE). This is a persistent phenomenon that raises all prices, and where sectoral variations overlap. On the other hand, we have deflation, which corresponds to the downward trend in prices.

Between the two, there is disinflation, which corresponds to the decline in the rate of price increases.

Finally, ‘persistence’ because we can have a rise in prices from one month to the next. Inflation is very seasonality, with variations returning from one month to the next each year, such as the effect of the balance periods in January and July, which leads to temporary declines in inflation month on month.

DIFFERENT TYPES OF INFLATION MEASURES IN EACH COUNTRY

Each country or economic area has its own indicators, which are calculated by the national statistical agencies:

In France,

Inflation is measured monthly by INSEE through the Consumer Price Index (CPI) and the Harmonised Index of Consumer Prices (HICP). The latter index, as well as those produced by the different statistical bodies of the member countries of the European Union, is used by Eurostat (the European body responsible for the production of harmonized European statistics) to calculate inflation in the euro area and in the European Union.

At EU level,

According to the harmonised methodology (HICP), Eurostat calculates average inflation in the 20 euro area countries weighted by the GDP of each country. It is this indicator that is directly targeted by the ECB's monetary policy with a target of 2%.

In the United States,

There are two indicators: The ICC and the PCE. Although the two measures follow the same trends, they are not identical.

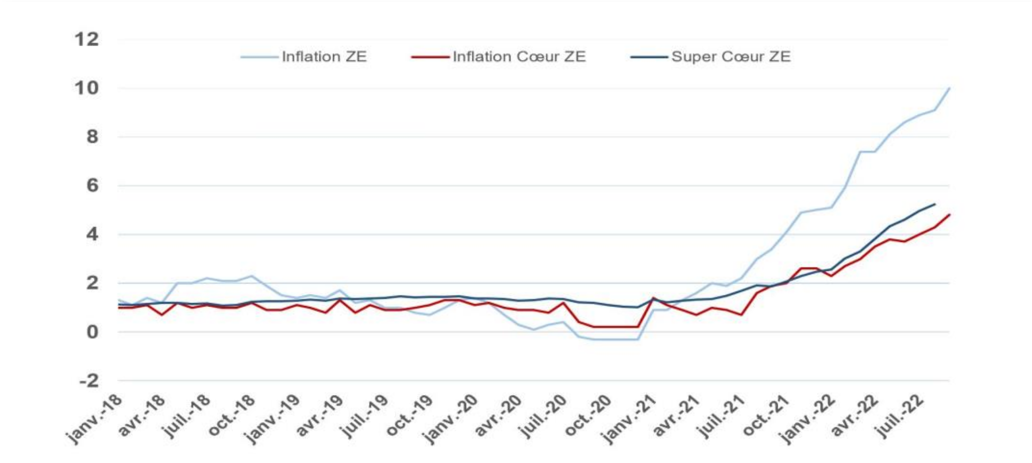
- Published monthly by the Bureau of Economic Analysis, the PCE index (personal consumption expenditures) is the US Federal Reserve's preferred inflation barometer, including its so called ‘core’ subversion (concept discussed in the next paragraph).
- Conversely, the CPI is also calculated monthly by the Bureau of Labour Statistics, which is used in many financial contracts (such as TIPS - US Treasury bonds indexed to US inflation) as well as to adjust social security payments for US citizens, for example.

Note that the CPI in France and Europe does not take into account the evolution of home prices at the time of purchase, unlike in the United States. The ECB is working on integrating the rent component into European inflation for the coming years (as in the US).

THE DIFFERENT SUB COMPONENTS OF INFLATION FOLLOWED BY ECONOMISTS

Economists also follow a subcomponent of total inflation known as core or core inflation. The core inflation index is a seasonally adjusted index that provides a fundamental trend in price developments. It reflects the profound evolution of production costs and the confrontation of supply and demand. It excludes prices subject to government intervention (electricity, gas, tobacco, etc.) And volatile price products (petroleum products, fresh produce, dairy products, meat, flowers and plants, etc.) They are subject to highly variable movements due to climatic factors or tensions in global markets.
The ECB is also monitoring a core inflation sub segment called ‘super core’ inflation, which excludes certain volatile components such as tourism and organised travel and allows a better reading of inflation trends. The chart below illustrates the dynamic differences between total core and super core inflation in the euro area since 2016: There is less volatility in the latter ‘supercore’ measure:

Expectations



Source: Bloomberg

THE MAIN FORWARD LOOKING MEASURES FOLLOWED BY CENTRAL BANKS IN MANAGING INFLATION

In addition to monitoring the various inflation figures, central bankers monitor a number of indicators to measure the effectiveness of their monetary policy to combat falling inflation expectations.

The ECB

Several indicators attempt to shed light on the trend and level of inflation expectations for the steering of the ECB's monetary policy in the euro area by questioning a wide range of different economic agents (financial markets, consumers, producers and professional forecasters) over different expectations horizons (for the following month, over the next 12 months, at 5 years). In terms of comparisons between these expectations and the level of inflation observed, none of these indicators is really predictive over the long term. Nevertheless, the ECB monitors all these indicators in order to determine the anchoring of economic agents' expectations around its target.

<table>
<tr><th>Investigative measures</th><th>Frequency Update</th><th>Horizons</th></tr>
<tr><td>European Commission investigation</td><td>Monthly
Quarterly</td><td>12 months (trend)
12 months (expected level)</td></tr>
<tr><td>ECB Professional Forecasters Survey</td><td>Quarterly</td><td>1.2 and 5 years</td></tr>
<tr><td>Consensus Economics Survey</td><td>Monthly</td><td>1 to 5 years</td></tr>
<tr><td>Z € barometer</td><td>Monthly
Quarterly</td><td>Current years, following year
2 to 4 years</td></tr>
<tr><td>World Economic Survey (IFO)</td><td>Quarterly</td><td>6 months</td></tr>
<tr><td>Business Climate Survey (PMI)</td><td>Monthly</td><td>Next month</td></tr>
<tr><th>Market indicators</th><th></th><th></th></tr>
<tr><td>Breakeven inflation linked sovereign bonds</td><td rowspan="3">At any time on the market</td><td>Bond curves available for maturities between 1 and 30 years</td></tr>
<tr><td>Zero coupon inflation swap rate</td><td>Bond curves available for maturities between 1 and 30 years</td></tr>
<tr><td>5 year inflation swap in 5 years</td><td>It is the 5 year forward in 5 years that is usually scrutinised by the BC but all combinations exist in the market.</td></tr>
</table>

The Fed

In the same way that the ECB uses surveys and market indicators, the FED follows a whole range of indicators on inflation expectations, the main ones of which are summarised in the table below. These indicators enable it to assess the effectiveness of the transmission of its monetary policy and are therefore also closely monitored by market participants to anticipate future monetary policy decisions.

Investigative measures	Frequency Update	Horizons
Household Inflation Forecast (Survey of Consumer Expectations - University of Michigan)	Monthly	1 year 5 years
Survey of Forecasters (SPF - Philadelphia Fed)	Quarterly	1, 2, 5 and 10 years
Conference Board Consumer Confidence Inflation Rate Expectation	Monthly	1 year
Common Inflation Expectations (CIE) (indicator created by the FED)	Monthly	Combines expectations over a short horizon (coming year) and a distant horizon (5 to 10 years)
Market indicators		
Breakeven inflation linked sovereign bonds	At any time on the market	Bond curves available for maturities between 1 and 30 years
Zero coupon inflation swap rate		Bond curves available for maturities between 1 and 30 years
5 year inflation swap in 5 years		It is the 5 year forward (in 5 years) that is generally scrutinized by the BC, but all combinations exist in the market

21/10/2022