Investment Managers

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Research & Strategy Insights

The return of inflation is a US story

Monthly Investment Strategy Oped

Gilles Moëc,
AXA Chief Group Economist,
Head of AXA IM Research

Chris Iggo,
AXA IM Chief Investment Officer,
Core Investments

Key points

- Inflation expectations in the US non-financial sectors continue to rise. However, we think a post-covid inflation regime change is not obvious, and if it materialised would remain limited to the US
- Equities have traditionally had better inflation adjusted returns
- High yield should resist the inflation hump better than other bond assets

The US inflation exception

US 10-year yields have retreated over the last few weeks below 1.70%, after their significant rise triggered by Joe Biden's victory. Both real rates and market-based inflation expectations have stopped climbing. The stabilisation in real rates would suggest that the Federal Reserve (Fed)'s dovish messaging – despite its refusal to tweak its quantitative framework to cap the rise in nominal yields – has finally convinced investors that the central bank may not be forced into a rushed catch-up in policy rates after tolerating above target inflation. The stabilisation in inflation expectations may be more surprising.

Indeed, indications the US will soon go through an "overheating phase" have been accumulating lately. The latest macro data releases confirm the US economy is improving fast. The March payroll report was very encouraging, with 916,000 more jobs, accelerating from an upwardly revised 468,000 in February. True, the gap relative to the pre-pandemic level remains quite significant (5.5%) but two-thirds of the job losses have now been recovered from the trough of March 2020. Slack is still plentiful in the US, but it is likely that the Congressional Budget Office (CBO)'s latest estimate of the output gap was too pessimistic. Based on the historical relationship, the unemployment rate now back at 6.0% is consistent with an output gap at -1.5% in Q1 2021, against a CBO forecast at -2.3%. Given the stronger than expected starting point, the additional fiscal push will bring the output gap squarely into positive territory, which usually is – not always – consistent with a rebound in inflation.

Businesses and consumers alike are upping their inflation expectations. The price component of the Services ISM index has shot up again to reach two standard-deviations above its long-term average in the March batch. This indicator has a decent predictive power on core inflation on a six-month horizon. When it comes to households' inflation expectations, in the latest Michigan survey, respondents put inflation over the next five years at 2.7%, just marginally down from March's near six-year high of 2.8%. This survey is a good predictor of actual inflation, with a lag of six months as well. A simple "augmented Phillips curve" model, using the unemployment rate and the Michigan inflation survey, would have core inflation back to 2% in the US in September, from 1.3% currently. But this is by no means the signal of an "inflationary spiral". These models have no

predictive power beyond six months, and it is unclear which forces would trigger another significant acceleration in consumer prices beyond the end of the year. The current fiscal stimulus will have been almost entirely exhausted by then – its relative drag competing with the private sector's reduction in excess saving will determine the pace of growth over the coming year. Meanwhile, President Biden's investment programme – which still remains to be endorsed by Congress – is likely to be spectacularly less supportive of the economy. This may explain the pause in the rise of market-based inflation expectations, which had recovered earlier than for businesses and households.

Still, it is possible to build a case for solid inflation post-Covid in the US, in contrast with its weakness since the great financial crisis. Biden could usher in a bigger political shift than expected. Beyond his fiscal activism, he is also a supporter of organized labour, and a re-regulation of the US labour market could pave the way to more dynamic wage growth.

The US is alone in this position though. Europe is lacking the massive fiscal push which would propel domestic demand far beyond the mechanical rebound post-Covid, while the underlying deterioration in the financial position of many of its firms makes it difficult to count on strong wage dynamics in the years ahead. The European Central Bank (ECB) is still hesitating to explicitly support "average inflation targeting" and tolerate inflation overshooting. Chinese policymakers are intent on avoiding over-stimulating the domestic economy and credit growth is being reined in. Elsewhere in key Emerging Markets central banks are now being forced to turn to a monetary tightening (Brazil, Russia, Turkey).

Of course, a return of inflation in the US would matter beyond its borders, given the dominance of the US dollar, the bond market and hence the potential for an undue tightening in market conditions elsewhere, but we continue to think it would not herald a general shift towards a new global inflation regime. Since "deglobalisation" has not materialised so far, even if the US is "alone at the top" in overheating, US consumers and producers will have the possibility to source products from countries less advanced in the cycle, hence ultimately limiting inflationary pressure. The path of the dollar will play as key a role in balancing these inflation pressures between regions as it will in setting the inflationary tone for many emerging markets.

Investing for the inflation hump

If inflation in the US is to be a little higher – coincident with strong economic growth – real (inflation adjusted) returns from equities are likely to be higher than those from fixed income markets. Of course, that could change if the Fed is forced into tightening monetary policy and thus reducing forward-looking growth expectations. But for the time being, a dovish Fed message should continue to be well received by equity investors. Lately, bond yields have moved up but remain well below zero in real terms. As such, this suggests low and possibly negative real returns to US Treasuries as inflation moves higher.

Over the last thirty years, real returns to US Treasury and corporate bonds were boosted by the consistent undershooting of inflation relative to expectations. However, in the last decade real returns to government bonds have fallen, reflecting the ultra-low interest rate environment since the global financial crisis. If core inflation does settle above 2.0% – in line with the Fed's target – and monetary policy support starts to be withdrawn, today's 1.60% 10-year Treasury yield itself does not bode well for real returns. As yields adjust higher, returns will be further impacted. It seems highly unlikely that real returns to Treasury investors will reach the 3.0% they averaged over the last 30-years or even the 1.5% average of the last decade.

Real returns from investment grade credit and high yield have been better than from Treasuries in recent times. Higher yields and strong capital returns related to quantitative easing have sustained higher real returns. In the high yield market, an index yield of 4.0% provides more cushion to real returns than in higher quality fixed income assets. The generally short duration nature of high yield will also be helpful if rate expectations rise again when the inflation numbers start to print higher. Certainly, in relative terms, high yield bond returns should be less impacted than more interest rate sensitive fixed income assets.

The last US expansion was a record one and only came to an end because of the pandemic. While this year is all about re-opening and recovery, the expansion should persist in the US as there appears to be no appetite for a premature tightening of either fiscal or monetary policy. Conditional on inflation not spiralling higher, this suggests that equity returns will continue to dominate. Over the last three decades, real US equity returns (nominal returns deflated by core consumer price index inflation) have been 2.5 times higher than real returns from Treasuries and almost double returns from credit. In the last decade, the differences have been even starker. While dividend yields are modest (around 1.5% for the S&P500) earnings growth should help sustain attractive real returns even if current valuations continue to look expensive. It is early days, but the

Q1 earnings season has got off to a very strong start, led by better-than-expected results from the big Wall Street banks. Aggregate earnings expectations for the next year remain set for 20% growth.

It's important that investors follow the inflation debate and the data closely. The worst-case scenario for the US would be that the Fed is forced to tighten early because of unexpected upside inflation surprises running into 2022. A tightening of financial conditions would slow growth and the deterioration in the growth/inflation relationship would undermine equity markets. Even then, over time, equities are likely to provide the best inflation hedge unless we experience 1970s style stagflation – something that is very much a distant tail-risk. Equally damaging for stocks would be a repeat of the deflation fears that surfaced in the early years of the century. Again, this is not on our radar, but it would be the only scenario in which bonds could sustainably outperform stocks.

Most of the time equities provide the best real returns. For the scenario we expect to play out over the next year or so, we suggest that they will continue to do so. It is likely to be true in Europe as well given that inflation is likely to be a lower hurdle for real returns. Bond yields have risen this year but so have inflation expectations which, if realised, will limit the real return profile for fixed income. Over time it seems likely that bond yields will rise further and eventually will offer better prospective real returns. However, the evolution of the business cycle until then, even with the upside risks to inflation discussed above, should mean equities are more likely to be the better "inflation asset".

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Recommended asset allocation

Asset Allocation	Rating	Last change
Key asset classes		
Equities	Positive	
Bonds	Negative	
Commodities	Neutral	▼ Downgrade
Cash	Negative	
Equities		
Developed		
Euro area	Positive	▲ Upgrade
UK	Positive	
Switzerland	Neutral	
US	Positive	
Japan	Neutral	
Emerging & Sectors		
Emerging Markets	Neutral	
Europe Cyclical/Value	Positive	
Euro Opening basket	Positive	
Euro Financials	Positive	
US Cyclical/value	Neutral	
US Financials	Positive	
Global semiconductors	Neutral	▼ Downgrade
Fixed Income		
Govies		
Euro core	Neutral	
Euro periph	Neutral	
UK	Neutral	
US	Negative	
Inflation		
US	Neutral	
Euro	Neutral	
Credit		
Euro IG	Neutral	
US IG	Neutral	
Euro HY	Neutral	
US HY	Neutral	
EM Debt		
EM bonds	Neutral	

Legends: Negative | Neutral | Positive — Last change: ▲ Upgrade | ▼ Downgrade

Source: AXA IM Macro Research – As of 21 April 2021

Macro forecast summary

Real GDP growth (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
World	**-3.7**	**5.5**		**4.3**	
Advanced economies	**-5.3**	**5.1**		**4.0**	
US	**-3.4**	**6.9**	5.7	**4.5**	4.0
Euro area	**-6.8**	**3.8**	4.3	**3.6**	4.2
Germany	**-5.3**	**2.4**	3.4	**3.3**	3.8
France	**-8.3**	**6.0**	5.5	**3.6**	3.7
Italy	**-8.9**	**4.5**	4.2	**4.1**	4.0
Spain	**-11.0**	**4.5**	5.7	**4.7**	5.7
Japan	**-4.9**	**2.9**	2.8	**2.5**	2.3
UK	**-10.0**	**5.3**	4.6	**6.7**	5.8
Switzerland	**-3.0**	**3.4**	3.2	**2.9**	2.9
Emerging economies	**-2.7**	**5.7**		**4.5**	
Asia	**-1.5**	**7.4**		**5.1**	
China	**2.3**	**8.5**	8.4	**5.5**	5.4
South Korea	**-1.0**	**3.5**	3.5	**3.0**	3.1
Rest of EM Asia	**-6.0**	**6.5**		**4.7**	
LatAm	**-7.3**	**4.0**		**2.8**	
Brazil	**-4.1**	**3.0**	3.3	**2.3**	2.4
Mexico	**-8.5**	**4.7**	4.4	**2.5**	3.0
EM Europe	**-2.3**	**3.1**		**3.6**	
Russia	**-2.8**	**1.8**	2.9	**2.5**	2.6
Poland	**-2.7**	**3.3**	4.1	**4.6**	4.7
Turkey	**1.6**	**4.5**	5.1	**4.6**	3.9
Other EMs	**-3.7**	**3.3**		**4.1**	

Source: Datastream, IMF and AXA IM Macro Research – As of 21 April 2021

* Forecast

CPI Inflation (%)	2020	2021*		2022*	
		AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	**0.8**	**1.7**		**1.4**	
US	**1.2**	**2.3**	2.4	**2.2**	2.2
Euro area	**0.3**	**1.5**	1.5	**1.1**	1.3
Japan	**0.0**	**-0.3**	-0.1	**0.5**	0.5
UK	**0.9**	**1.9**	1.6	**1.7**	2.0
Switzerland	**-0.7**	**0.1**	0.3	**0.4**	0.5

Source: Datastream, IMF and AXA IM Macro Research – As of 21 April 2021

* Forecast

These projections are not necessarily reliable indicators of future results

Forecast summary

Central bank policy
Meeting dates and expected changes (Rates in bp / QE in bn)

		Current	Q1 -21	Q2-21	Q3-21	Q4-21
United States - Fed	Dates	0-0.25	26-27 Jan 16-17 Mar	27-28 Apr 15-16 Jun	27-28 Jul 21-22 Sep	2-3 Nov 14-15 Dec
	Rates		unch (0-0.25)	unch (0-0.25)	unch (0-0.25)	unch (0-0.25)
Euro area - ECB	Dates	-0.50	21 Jan 11 Mar	22 Apr 10 Jun	22 Jul 9 Sep	28 Oct 16 Dec
	Rates		unch (-0.50)	unch (-0.50)	unch (-0.50)	unch (-0.50)
Japan - BoJ	Dates	-0.10	20-21 Jan 18-19 Mar	26-27 Apr 17-18 Jun	15-16 Jul 21-22 Sep	27-28 Nov 16-17 Dec
	Rates		unch (-0.10)	unch (-0.10)	unch (-0.10)	unch (-0.10)
UK - BoE	Dates	0.10	4 Feb 18 Mar	6 May 24 June	5 Aug 23 Sep	4 Nov 16 Dec
	Rates		unch (0.10)	unch (0.10)	unch (0.10)	unch (0.10)

Source: AXA IM Macro Research - As of 21 April 2021

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Our Research is available online: http://www.axa-im.com/en/insights

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