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Equity Strategy Flash

What to favour in the event of a gradual uptick in inflation?

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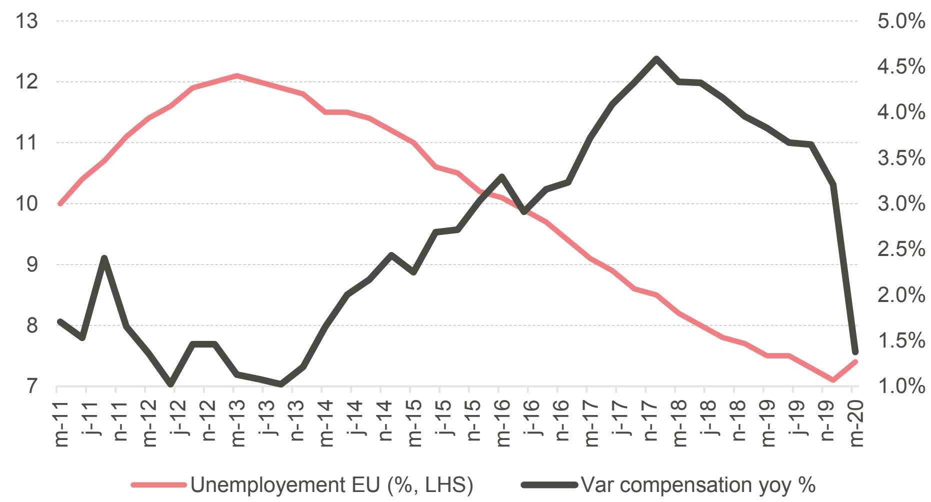
Discussing a return of inflation may seem irrelevant at a time when there is so much downward pressure on prices (unemployment, raw materials). Inflation swaps are nonetheless picking up. Perhaps this is due to the effects of several long-term trends (ageing of the population, de-globalisation, etc.) combined with base effects on raw materials. While this return is likely to be gradual, it will imply an adjustment of portfolios. Value (banks) and commodities (mining) should benefit, especially if Europe manages to agree on its stimulus plan.

Set for a gradual upturn in inflation in 2021?

If we exclude the obvious inflation of risky assets resulting from money creation, talking about price increases may seem a rather strange idea at present. Indeed, the consequences of the pandemic are combining to exert downward pressure on prices.

Unemployment is rising (9.2% expected by our economists vs 7.6% in 2019), which is not conducive to wage increases (the main channel for transmitting inflation to the price of goods and services).

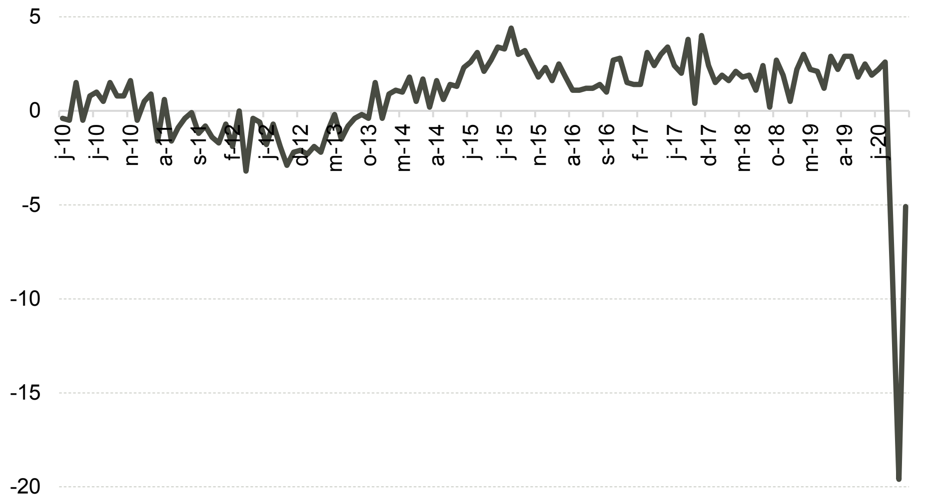
Trend in unemployment in the eurozone (%) and y-o-y % change in wages



Sources: ODDO BHF Securities, Eurostat

With the contraction in retail sales, stocks have tended to rise.

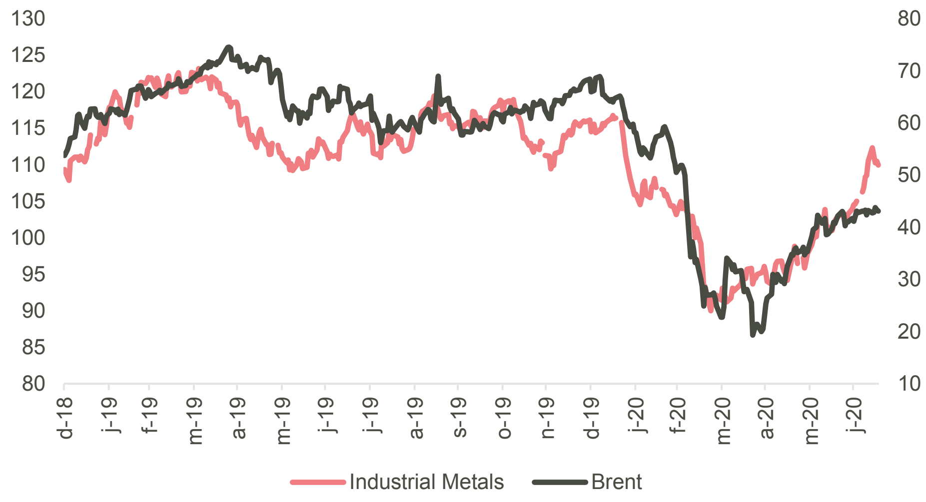
Trend in retail sales in the eurozone (y-o-y % ch.)



Sources: Bloomberg, Eurostat

And lastly raw material prices are, on average, well below the level for the corresponding period of 2019.

Oil price, industrial metals



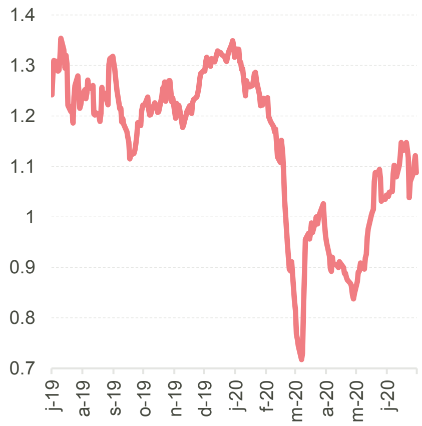
Source: Bloomberg

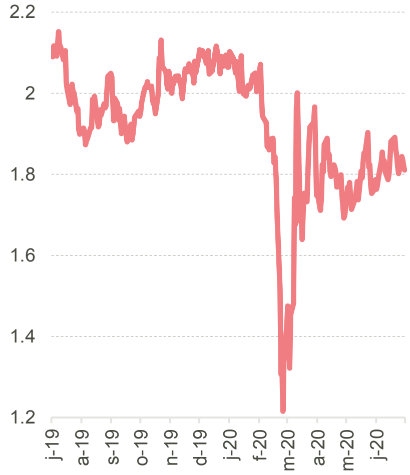
In short, the die is cast and our economists are expecting a 40bp decline for the current year (0.8% vs 1.2% in 2019e).

So why bother with this question when the danger seems to be, at this stage, of a deflationary nature? Quite simply because a number of elements argue in favour of a gradual return of inflation as early as next year. And this is of interest to us because this return of inflation, were it to materialise, would inevitably have repercussions on the equity markets, particularly in terms of management style.

The examination of inflation expectations, via inflation swaps, sends a similar signal in the US and in Europe.

5-year inflation swaps in 5 years Europe (left) and US (right)



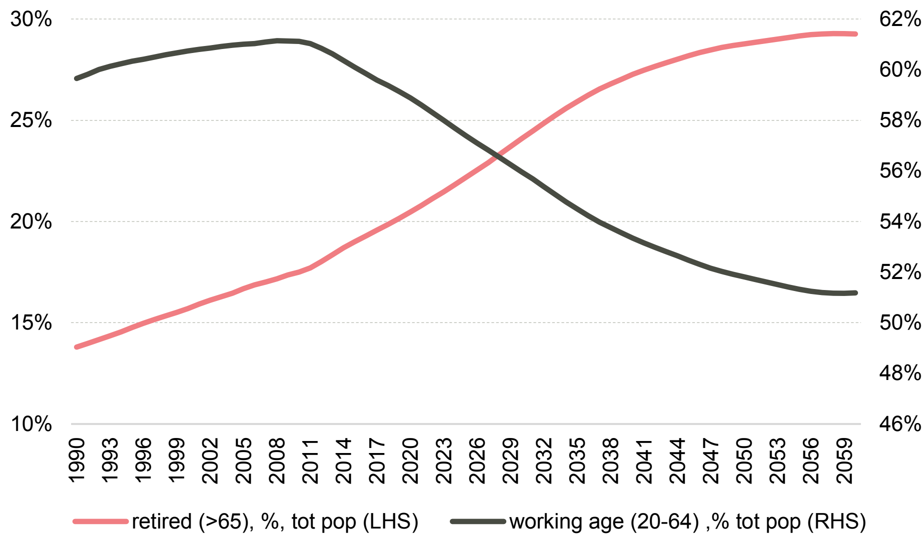


Source: Bloomberg

Indeed, it must be acknowledged that several long-term trends are combining to stoke a gradual increase in prices in the coming years. We identify five:

1. **The ageing of the population.** This trend is a worldwide one and not exclusive to Europe. It is fuelling retirees' share of the total population. Note that this segment is growing faster than the active workforce However, retirees are by definition "pure" consumers and contribute to the increase in demand for consumer goods. Ironically, the monetary policy currently being conducted reinforces this consumer trend since savings are no longer remunerated.

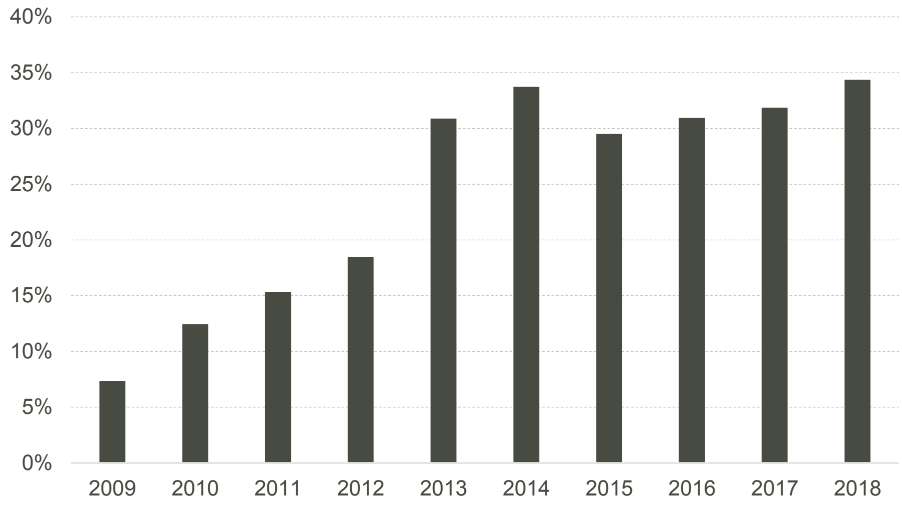
Ageing of the population (EU-28) a major trend (>65 years old and 20-64 year olds as a % of the population)



Sources: ODDO BHF Securities, OECD Stats

2. **The process of total or partial repatriation of value chains has been put under the spotlight by the pandemic. Overall, this trend is leading to an increase in production costs linked to the differential in unit labour costs, which are 70% higher in the economies of the eurozone than in EM countries**. It now appears dangerous to depend on distant regions for the supply of essential components. However, current events have masked the fact that this process had already been under way for several years. The proportion of imports affected by tariff and non-tariff barriers has grown steadily in recent years at the global level, from 7.4% in 2009 to 34% in 2018. However, this dissemination process of the increase in prices will be gradual…

Share of imports hit by trade restrictions at the global level (as a % of the total)



Sources: ODDO BHF Securities, Global Trade Alert

3. **A new organisation of work could subsist in the aftermath of the COVID-19 crisis, at least until an effective vaccine or treatment is available and widely disseminated worldwide.** The various measures implemented in terms of social distancing, the organisation of work, result in a decline in hourly productivity and therefore an increase in unit output of production. It is difficult to think that businesses are not seeking to offset the resultant erosion of margins via an increase in selling prices.
4. **The large-scale application of elements linked to "Modern Monetary Theory" will trigger wage demands. The latter already exist**, notably for professions that have played an essential role during the most stringent part of the lockdown period. For example, a significant number of these demands have been met in France for healthcare workers (€ 7bn), food retail, etc.

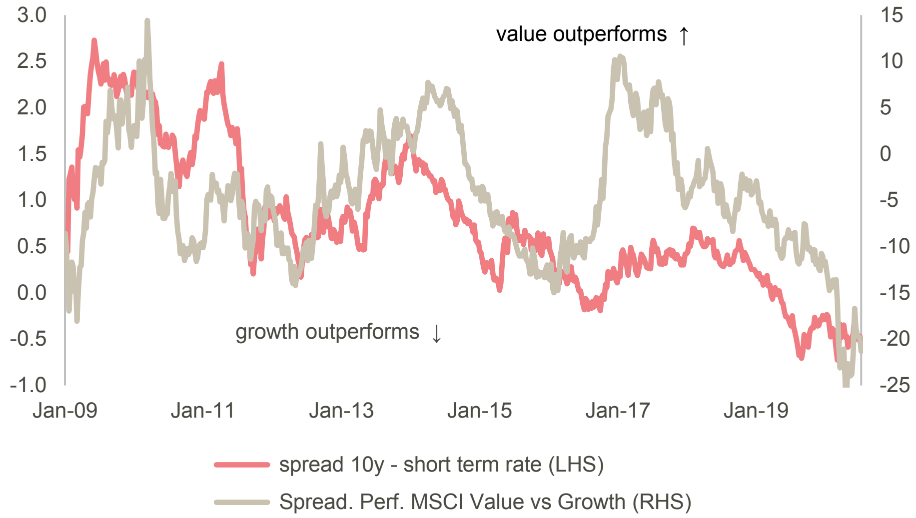
   In parallel with this trend, the effects of the monetary policy currently being conducted must be factored in. Unless inflation is pushed close to the 2% target, the effects on inflation of risky assets and real estate tend to favour the wealthiest quintiles of the population. This aspect is particularly prevalent in the US and is fuelling the debate on federal minimum wage level in the run-up to the election. Donald Trump AND Joe Biden have taken up the topic and both are arguing in favour of a significant increase ($ 15 per hour)[1].
5. **The development of "green" energy, as a replacement for fossil fuels, is poised to trigger a debate on supply costs**. By its very nature, intermittent sustainable production is indeed more costly. The take-off of unconventional oil production has been a powerful disinflation driver. Short term, historically low prices of raw materials in H1 2000 argue in favour of a positive base effect in H1 2021e (possibly even as of H2 2020e) which will be apparent in headline inflation.

These factors, excluding base effects on raw materials, are characterised by significant inertia and there is no reason to believe that their trajectories could undergo a short-term inflection. Investors are therefore justified in thinking that inflation may be a factor to be incorporated into their investment strategy. What consequences can be expected?

In terms of management style, a rise in inflation is in theory synonymous with a preference for value, via the rise in interest rates that it is supposed to engender. This naturally affects the sectors and stocks with the highest terminal values. In other words, it amounts to a sale of duration. Historically, an outperformance for value is indeed seen when the yield curve steepens.

[1] *https://www.bloomberg.com/news/articles/2019-06-21/trump-says-he-s-weighing-democrats-plan-for-15-minimum-wage?sref=ndTEDqb1*

Value – growth performance spread and Bund – ECB policy rate spread

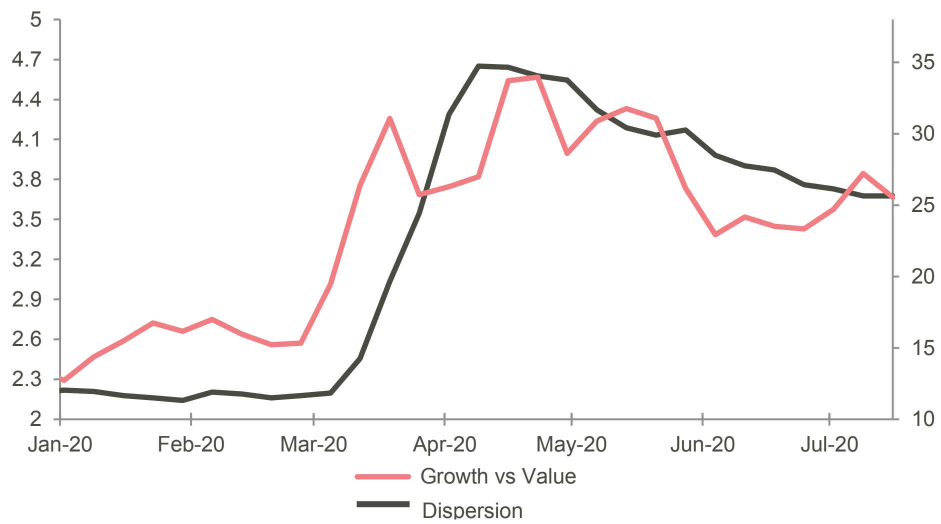


Sources: ODDO BHF Securities, Thomson Reuters Datastream

Obviously, the current circumstance argue for concerted action from central banks to keep rates low and the yield curve flat. Nevertheless, the possible implementation of the € 750bn European stimulus plan in 2021, therefore at a time when inflation could be showing signs of "life", would strengthen the macroeconomic growth outlook and could fuel the prospect of a start to monetary normalisation …

And stronger growth, spread more evenly through the economy, helps reduce the dispersion of earnings forecasts In doing so, it reduces the incentive to invest in sectors/stock with high P/Es, synonymous with high visibility. The automatic recovery in activity with the easing of the lockdown favours this trend.

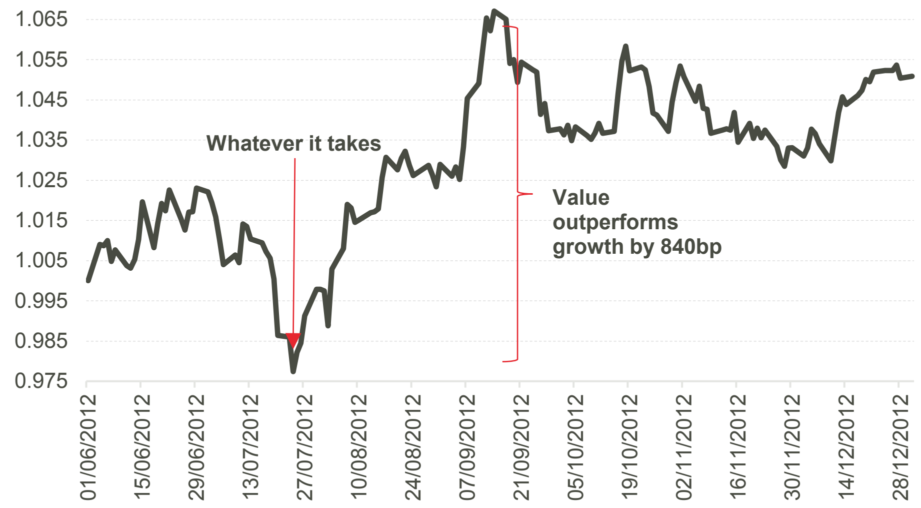
Dispersion of consensus forecasts and growth / value performance



Source: Bloomberg

Historically, the episodes associated with the prospect of a perpetuation and further integration of the European project result in an outperformance for value relative to growth. This was notably observed in 2012, following Mario Draghi's announcement that the ECB would do "whatever it takes" to ensure the survival of the euro.

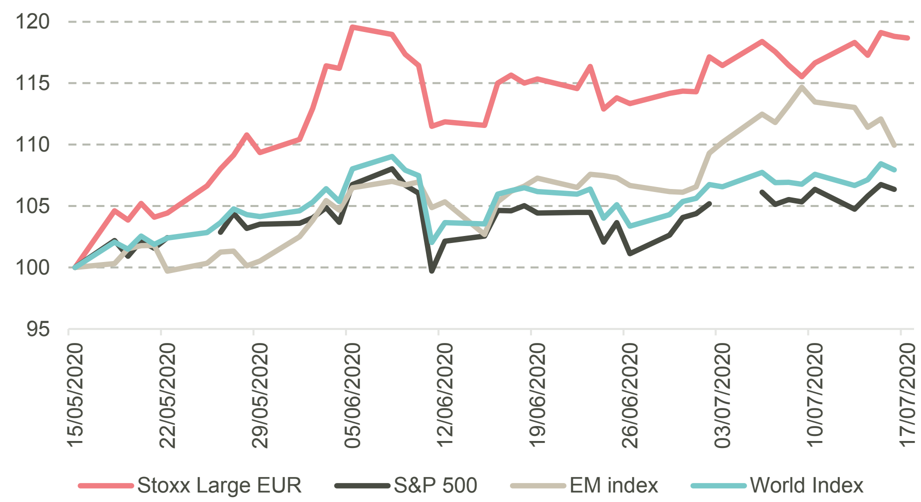
Value outperformance is associated with European integration



Sources: ODDO BHF Securities, Bloomberg

While European equities have sharply outperformed international indexes since the Franco-German announcement of the stimulus plan project, value has lagged behind.

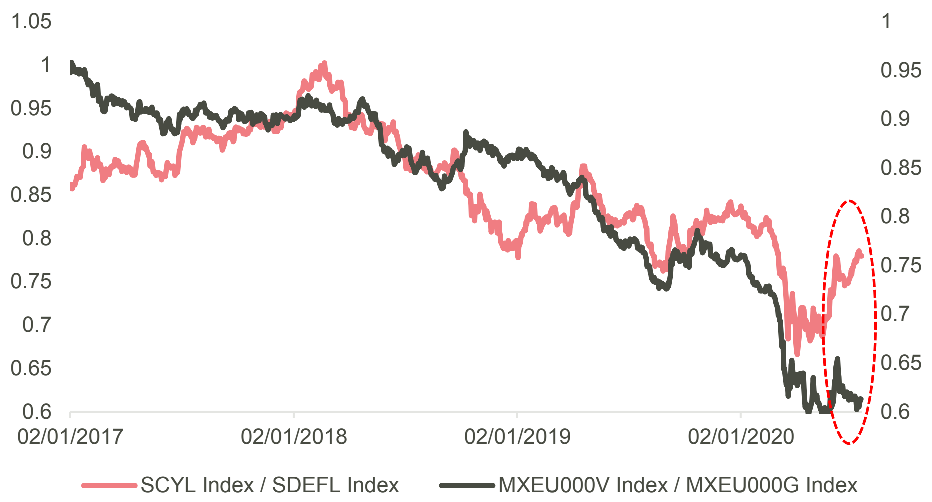
Europe leads the way for once …. base 100 = 1/5/2020 all indexes in euros)



Source: Bloomberg

This lag is odd in the light of the outperformance shown by cyclical stocks relative to defensives in the same period. Usually, these relative performance pairs tend to move in tandem, which makes sense since both are sensitive to the prospect of an improvement in the cycle…And an improvement is automatically inevitable, at least via base effects.

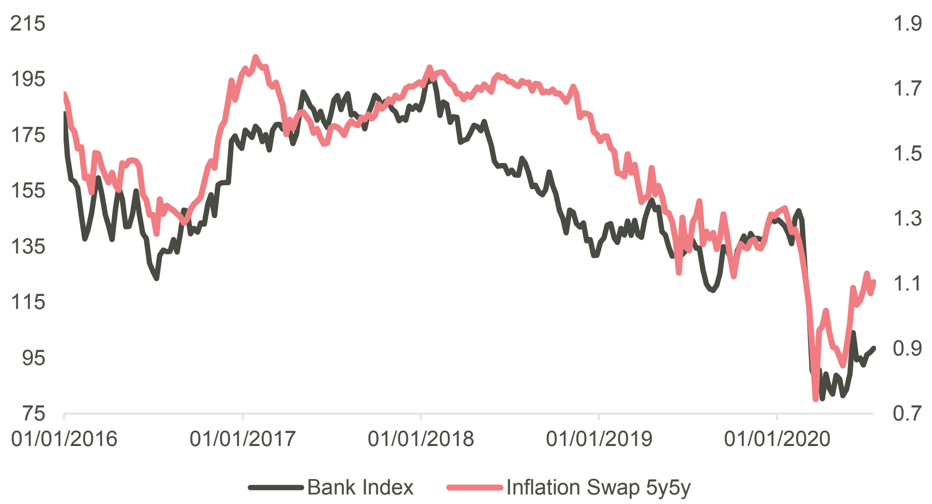
Cyclicals / Defensives and Value / Growth: the strange decoupling



Source: Bloomberg

Obviously, the European value call is not necessarily very enticing since it mainly implies taking on exposure to the most "problematic" sectors, namely financials and automotive. Nevertheless, the rise in inflation expectations, which we underlined above, is in general associated with a positive performance for the financial sector… and this has not yet been seen…

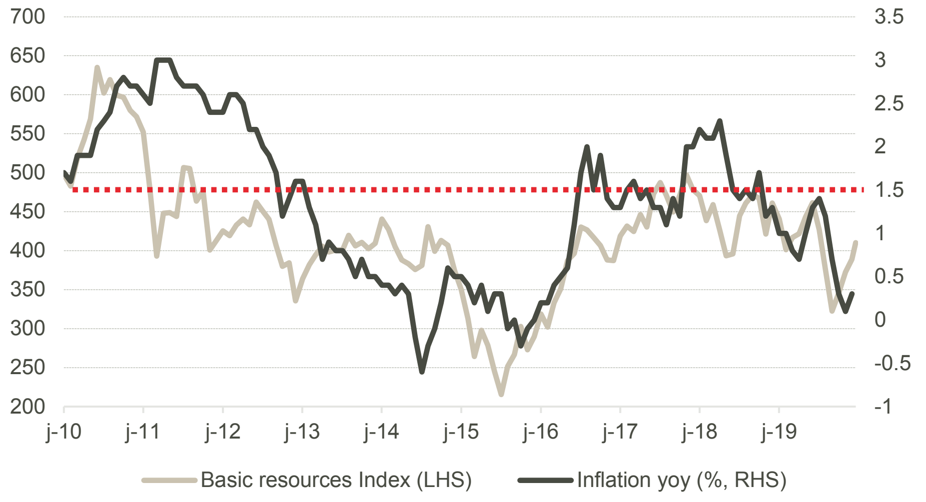
5y5y inflation swap and financials…: they usually go hand in hand



Sources: ODDO BHF Securities, Bloomberg

Last, a rise in inflation, against the backdrop of a recovery in PMI indexes, also favours the raw materials sector (the users of which are price takers). If the 1.6% inflation target set by our economists in 2021e is achieved, this would imply a target of 472 for the SXPP index (+15%).

Inflation and raw materials go well together

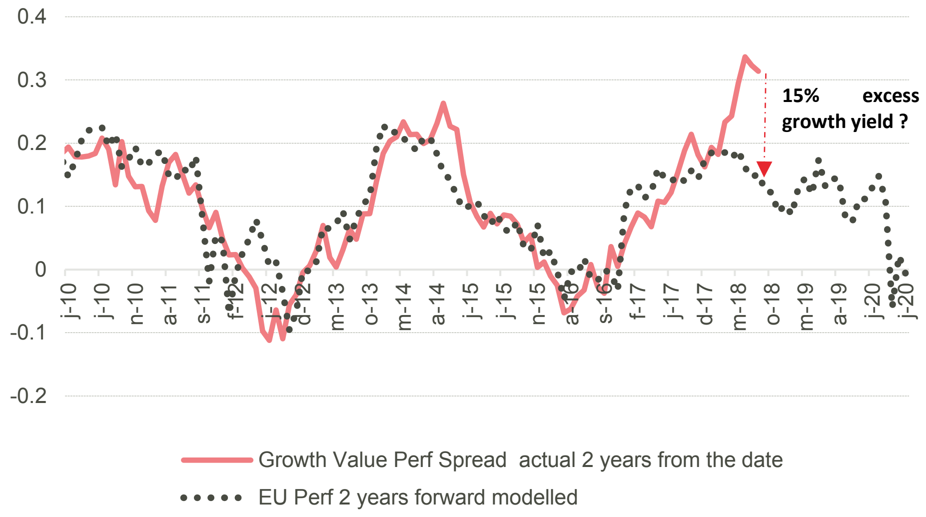


Sources: ODDO BHF Securities, Bloomberg

So can we talk of a clear value signal? In the medium to long term this may be doubted as the financial repression context provides abundant "ammunition" to those who would liken growth stocks to stocks offering attractive steady income amid very low bond yields.

Conversely, the prospect of a gradual return of inflation and the possible adoption, probably with a typically European roundabout trajectory and slowness, of a European stimulus plan with a federal dimension, argue for a correction of the growth yield anomaly since the start of the year. This is moreover in substance the message from our forecasting model for the two-year yield gap between the MSCI Growth and Value.

Future growth-value performance in Europe: set for a correction of the growth yield anomaly currently observed?



Source: Bloomberg

This potential correction should in our view be taken into account in the construction of portfolios incorporating more of a value and cyclical dimension than was preferred at the height of the health crisis. Obviously an uncontrolled resurgence of the epidemic, and a collapse of the "European dream" would render this recommendation null and void…

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