MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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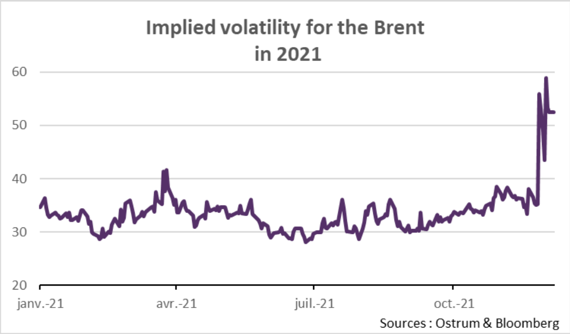
Topic of the week: Food risk?

- **Environmental problems are worsening. Rising food prices pose a significant risk for 2022. The pandemic and the effects of climate change are reducing food security especially for poor countries;**
- **While undernutrition has declined significantly over the past several decades, food insecurity has rebounded over the past several years, a trend accelerated by the Covid crisis. The human consequences could be severe;**
- **For the economy there are three main consequences: (1) yet another inflationary shock, especially in emerging countries where the food component is stronger, (2) a reduction in consumption, (3) political instability in the most vulnerable countries.**

Market review: Powell throws in the towel

- **The Fed takes note of the risk of inflation;**
- **The Omicron variant brings renewed uncertainties;**
- **High volatility in equity markets, sharp curve flattening;**
- **OPEC+ increases oil production… under some conditions.**

Chart of the week



Market nervousness has increased significantly. Implied volatility on oil has doubled in recent weeks. It is the same for equities with a strong increase in VIX (volatility expected on the S&P 500) and V2X (the equivalent on the EuroStoxx), MOVE (implied volatility on the Treasury) and finally on foreign exchange.

While stress seemed to be concentrated on the yield curve in November, the spread of the virus and uncertainties related to inflation and growth are pushing other asset classes to expect a more uncertain future.

Figure of the week

72%

Source : Ostrum AM

The percentage of European companies in the EIB's investment survey that say Covid will have a long-term impact on their business.

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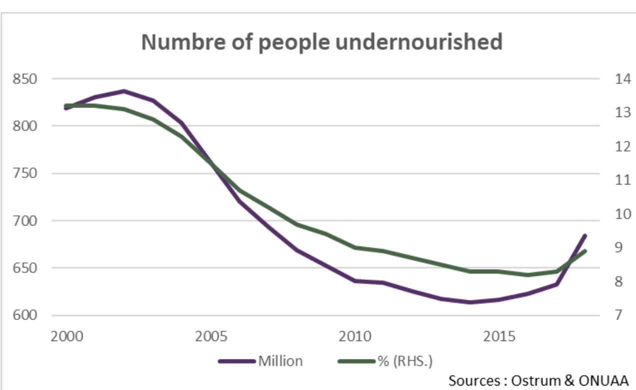
Topic of the week

Food risk?

Environmental problems are getting worse. You liked the energy crisis? You will love the food one! On the food front, the global situation has improved over the past two decades with a significant decline in malnutrition. But, paradoxically, vulnerability has increased significantly in recent years. The energy crisis and supply problems are undermining global food production. The risks of price increases, or even shortages, are becoming more and more important. This will have serious human consequences but also economic impacts with, in the extreme, potential social movements that should not be underestimated.

A precarious global situation

The world food situation has definitely improved over the past decade. We use data from FAO, the Food and Agriculture Organization of the United Nations. Unfortunately, these data are only available from 2000 to 2018. However, they show a sharp decrease in the number of undernourished people, more than 150 million while the population has grown considerably over the same period (+1.3 billion).

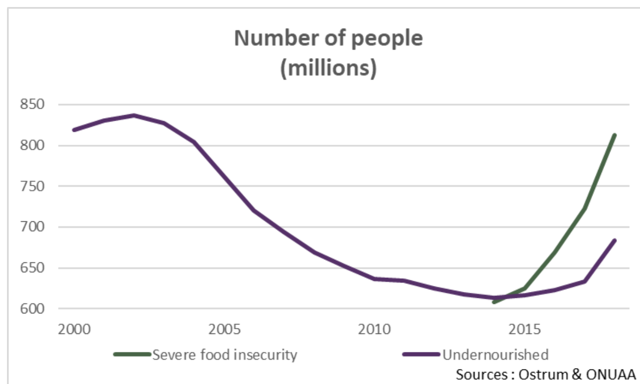


As a result, the proportion of undernourished people has fallen dramatically from 13.2% of the world's population in 2000 to 8.9% in 2018. At this rate, we could be approaching zero around 2030. Wishful thinking…

However, a more careful analysis shows a more precarious situation. On the one hand, the downward trend had reversed by the end of the last decade, and UNOSA did note in its latest report that "Even before the onset of Covid-19, the world was already not on track to eliminate hunger and malnutrition by 2030."

The organization estimates that 720 to 800 million people were affected by hunger last year as a result of the pandemic. This is $161 million more than in 2019, an increase of 13%.

On the other hand, the level of precariousness has continued to rise. The number of people in food insecurity increased sharply between 2014 and 2018 (unfortunately the only data available), reaching more than 800 million while people in "moderate" food insecurity went from 1.70 billion to 2.13 over the same period, or more than 27% of the world's population.

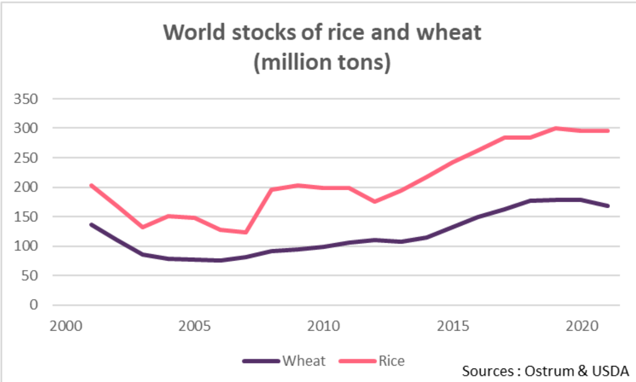


So, the situation, on average, has definitely improved. A finding corroborated by the fact that the number of people living in "absolute poverty" has also declined considerably over the same period. On the other hand, the situation seems increasingly precarious and therefore, despite the progress made, the ability to absorb a shock has paradoxically deteriorated. And UNOSA concludes, "The urgency of strengthening their [poor countries] capacity to withstand shocks cannot be overstated."

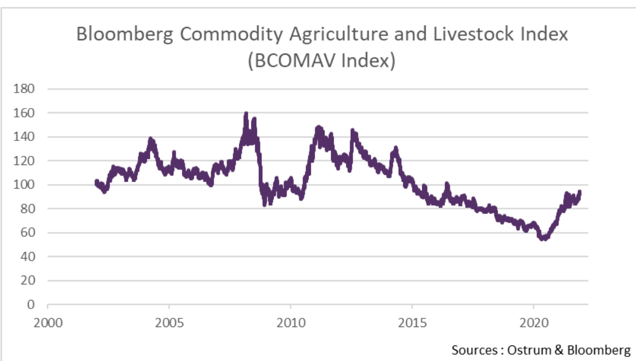
Volumes and prices: the current picture

Along with disruptions in industrial production, Covid has created problems in agricultural production. With a similar result, an increase in the prices of agricultural commodities.

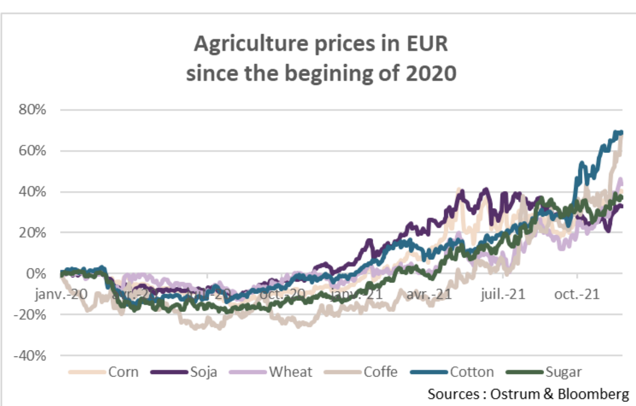
However, the current situation on cereals is mixed. Wheat stocks are declining due to poor weather conditions, while rice is not. Asia and the Middle East, big consumers of rice, will be less impacted. Estimates by the US Department of Agriculture do show a 5% decline in world wheat stocks in 2021, so nothing dramatic, while rice stocks are stable with a mere -0.2% decline.



In terms of prices, however, the increase is very extensive. The chart below shows the evolution of the Bloomberg index (in USD). Since last year's lows it has gained about 60%, although its level has only been returning to its long-term average.



A more detailed analysis shows that the increase is very widespread. The following chart shows the increase of the main "grains" and "soft commodities". The increase since the beginning of last year ranges from 40% to 80% (in EUR) for each of these basic materials. So, it's not a normalization after the pandemic-related drop, but it's an overreaction to the significant increase.



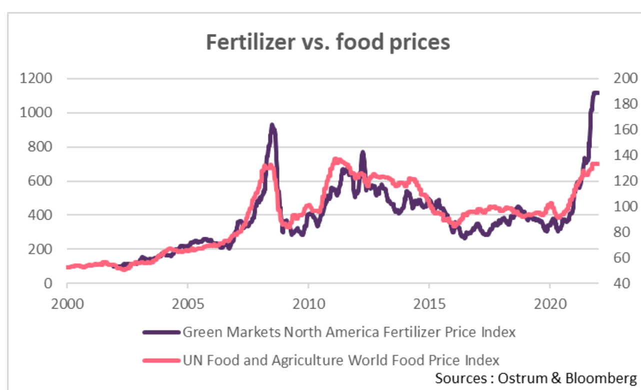
Worrying prospects

The problem is unlikely to go away quickly. On the one hand, production congestion affects agriculture as it affected industry. But in addition, the price of fertilizers has recently exploded. The blame, once again, for the bottlenecks that emerged as a result of the pandemic. But this is also due to the explosion in energy prices, in particular the price of gas, which goes into the manufacture of certain chemical compounds. Even the IMF was moved by this and dedicated a blog to the subject: https://blogs.worldbank.org/opendata/soaring-fertilizer-prices-add-inflationary-pressures-and-food-security-concerns

To top it all off, emerging shortages have led to protectionist behaviors in some countries. For example, China announced the suspension of fertilizer exports until June 2022 to ensure national availability in a context of food security. Brazil, on the other hand, wants to develop its local production to avoid external dependence.

Svein Tore Holsether, the CEO of Yara (Norwegian chemical company, largest distributor of crystallized fertilizers) said, "I want to say loud and clear right now that we risk a very low harvest in the next season." Since September, it has reduced its ammonia production by nearly 40% due to energy costs.

So, there is clearly a quantity problem. Moreover, the price of these same fertilizers has historically been closely linked to the evolution of agricultural prices themselves (cf. the graph below). This is essentially for two reasons. On the one hand, fertilizer prices are an important component of the cost structure of producers. On the other hand, the shortage of fertilizers is expected to lead to lower yields, and thus worsen the shortage of food.



Consequences

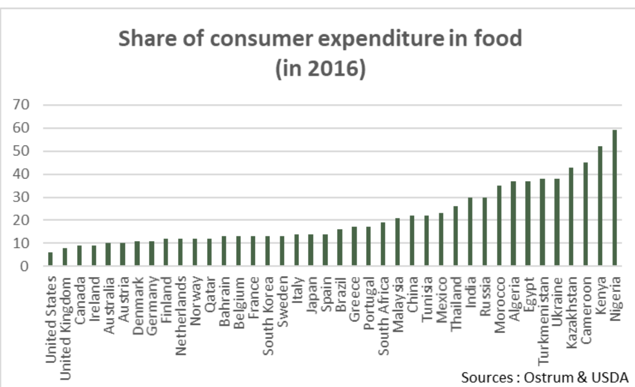
While 800 million people around the world do not have enough to eat, a significant increase in prices and/or insufficient production could have serious human consequences. On the economic front, it has three impacts: more inflation, less consumption and political instability.

More inflation

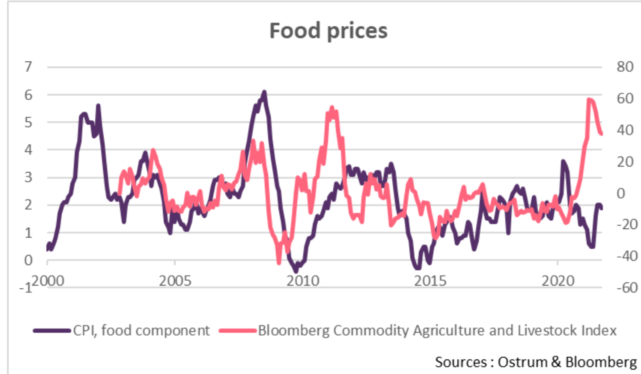
The first consequence is an increase in the price index. An additional temporary effect. In the case of OECD countries, food constitutes about one tenth of the price index.

In contrast, in the case of emerging countries the proportion may be much higher. A proportion of one quarter (e.g., Tunisia, Mexico or Thailand) or one third (e.g. Russia, Morocco or Algeria) is common with, for the highest figures, an African podium made up of Nigeria (59%), Kenya (52%) and Cameroon (45%).

An increase in agricultural prices in these countries will therefore go far beyond a simple undesirable effect on inflation and create very difficult situations.



However, we must be careful, the food component of the consumer price index obviously follows the price of raw materials but with a much smaller amplitude: when you buy your sandwich at noon you also pay for transport, work, packaging, baker's margin… The food index in the Eurozone is currently only +1.9%, despite the much larger increase in the price of raw materials.



Less consumption

This increase in prices will also be the equivalent of a tax for the consumer. And will therefore reduce his purchasing power. Once again, consumers whose food constitutes the largest share of consumption, and therefore the poorest, will be the most affected.

The past has even given rise to an economic oddity: Giffen's good. It is a commodity whose price increases directly increase demand. For the record, the economist Robert Giffen had observed, during the Irish famine, that when the price of food increased, consumers could no longer buy only potatoes to feed themselves: the more the price of potatoes went up, the poorer consumers became, and had to increase the proportion of potatoes in their diet, which led to higher potato prices.

A frightening vicious circle exists for goods that have three characteristics: (1) basic goods, (2) no substitute goods, (3) which represent a significant part of the buyer's income.

Political instability

Beyond the purely economic aspect, a sharp rise in food prices can also create political instability. The countries where the food component accounts for an important part of consumption are, of course, also the poorest countries and therefore the impact of a price increase will be all the more painful. We can also add, unfortunately, that these countries are also those where income disparities are greatest, and therefore populations at risk are particularly vulnerable.

The last historical precedent, the "Arab Spring" of 2011 (Tunisia, Egypt, Algeria) was certainly motivated by questions of democracy and individual freedom but it also began on much more prosaic considerations, a spike in food prices that weakened the most vulnerable populations. A resurgence of such risks in emerging economies, already affected by the Covid crisis, is a very plausible scenario.

At the very least, this can lead to a desire on the part of states to subsidize food and thus to deteriorate their public and external accounts.

Conclusion

Environmental problems are getting worse. “Hope for the best but prepare for the worst,” say the Brits.

Unfortunately, food fragility is indisputable for a large part of the world’s population. Current agricultural production and fertilizer production leave little hope for future crop volumes.

Shortages seem inevitable, so the question will be how big the crisis will be. The human impact is of course distressing; but the economic aspects should not be underestimated for market participants.

Stéphane Déo

Market review

Powell throws in the towel

Fed takes note of inflation amid rising health uncertainties

Financial markets have been extremely volatile amid health risks and signals of monetary tightening. Intra-day volatility appears to be fueled by algorithmic trading reacting to the headlines as the end-investor community still appears prone to buy on dips. While the drop in equity indices remains modest in view of the 2021 bullish run, market nervousness is palpable and pockets of liquidity are likely to appear, particularly in credit. Inconsistent communication from vaccine producers about the South African variant arguably amplified stock price swings. At this stage, the higher transmissibility of the Omicron variant does not appear to result in vaccine resistance or increased lethality risk. The next few weeks will be decisive in validating or invalidating these hypotheses. The flattening of yield curves in the United States as in Europe reflects the investors' need for security. The Fed's pivot, though behind the curve, spurred an upward move in short-term yields as meetings of the Fed, the ECB and the BoE loom large in mid-December. Like the equity markets, corporate credit spreads react rather to the new monetary policy situation than to increased Covid risks. Volatility also rose in the currency market, including on the euro-dollar exchange rate. In emerging markets, the surge of the Omicron variant caused weakness in the South African rand while political interference in Mexico or Turkey weakened both the peso and the pound. The Turkish Central Bank intervened but the downward spiral seems out of control.

The international political situation remains tense. The situation at the Ukrainian border is a source of worry for the US Administration fearing a Russian intervention in support of pro-Russian separatists, the stake being to limit NATO's expansion to the east. Against this backdrop, Russia's support for OPEC+'s decision to raise production to 400k barrels per day by January 2022 came as a surprise. However, the oil cartel estimated the excess supply in the first quarter of 2021 at 3 mbpd, or even as much as 4.8 mbpd, in the event of an unfavorable Omicron scenario. In fact, elevated oil prices risk both accelerating negotiations with Iran (resulting in the resumption of Iran oil exports) and the rebound in US output production (which had already picked up to 11.6 mbpd at the end of November). Difficult China-US relations also bring their share of risk factors. After its chaotic initial price offering, Didi is withdrawing from the US listing following orders from Beijing, which appears unhappy with personal data transparency demanded by US authorities.

As concerns the economic situation, upbeat surveys keep hitting the wires in Europe and the United States. The PMI and ISM indicators reflect solid growth towards the end of the year, although potential Omicron variant disruptions may not be fully reflected in the survey. The US unemployment rate (4.2%) is back to the level of February 2020. On the other hand, Chinese growth remains weak and requires the Central Bank to provide monetary relief. The PBoC is arguably seeking to mitigate the risk of a credit crunch by lowering the reserve requirement ratio. The credit impulse (i.e. the year-on-year change in bank credit growth) continues to herald a sharp slowdown ahead, which forces China's Central Bank to intervene to ensure exchange rate stability.

The Fed's change of heart reflects the political stakes of rising inflation much more than a possible change in the economic environment. Powell threw in the towel on the supposedly transient nature of consumer price increases, paving the way for faster reductions in monthly asset purchases before raising interest rates. The pace of tapering will probably double. The curve flattening trend has strengthened further. Flows into US Treasuries funds jumped this week. The 30-year T-Bond is trading around 1.75% versus 2.4% in May. The 5s30s curve spread tightens to 55bp. The reach for convexity is justified by the higher bond volatility. Index-linked bonds underperformed as oil prices adjusted lower (down 10 $ over one month), volatility prompted flight-to-quality and more generally the Fed's hawkish pivot. Breakeven inflation rates (245bp) have in fact corrected by almost 30bp over the past month. Demand for inflation risk hedging remains strong, but flows into TIPS funds have slowed notably.

Credit spreads have been volatile last week following the sharp widening in CDS indices, with the iTraxx Crossover stabilizing around 280bp. The euro IG universe is tarding at an average spread of 104bp against Bunds (+ 2bp over the week) amid thin secondary market trading and little new issuance. Funds with excess cash may seek opportunities in secondary markets before a primary market revival in January. Volatility triggers a difference in performance between issues eligible to ECB programs and securities excluded from the CSPP. High yield widened by around 15bp last week despite some opportunistic buying from investors towards the end of the week. The spreads on speculative-grade debt stand at 347bp in euros and 325bp in dollars respectively.

After a very volatile week, the US indices plunged at the weekly close. The Nasdaq lost 2% on Friday. Sector rotations are significant in Europe, the rebound in banking stocks contrasting with the decline in defensive growth stocks. Value stocks offering a dividend outperformed the growth/quality group.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	06-Dec-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.73 %	+2	+0	-3
EUR Bunds 10y	-0.38%	-7	-10	+19
EUR Bunds 2s10s	35 bp	-9	-10	+22
USD Treasuries 2y	0.62 %	+14	+22	+50
USD Treasuries 10y	1.38 %	-12	-7	+47
USD Treasuries 2s10s	76 bp	-25	-29	-3
GBP Gilt 10y	0.75 %	-11	-9	+56
JPY JGB 10y	0.05 %	-3	-2	+2
€ Sovereign Spreads (10y)	**06-Dec-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	36 bp	-1	+1	+12
Italy	129 bp	-1	+13	+18
Spain	73 bp	-1	+5	+12
Inflation Break-evens (10y)	**06-Dec-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	164 bp	+5	+13	-
USD TIPS	246 bp	-8	-9	+48
GBP Gilt Index-Linked	419 bp	+1	+17	+119
EUR Credit Indices	**06-Dec-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	103 bp	-8	+15	+11
EUR Agencies OAS	52 bp	+0	+8	+11
EUR Securitized - Covered OAS	49 bp	+0	+7	+17
EUR Pan-European High Yield OAS	343 bp	-10	+25	-15
EUR/USD CDS Indices 5y	**06-Dec-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	58 bp	+1	+10	+10
iTraxx Crossover	282 bp	+0	+42	+41
CDX IG	58 bp	+3	+9	+8
CDX High Yield	328 bp	+10	+41	+35
Emerging Markets	**06-Dec-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	386 bp	-5	+29	+35
Currencies	**06-Dec-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.130	+0.04	-2.52	-7.54
GBP/USD	$1.327	-0.32	-2.14	-2.9
USD/JPY	¥113.1	+0.38	+0.11	-8.71
Commodity Futures	**06-Dec-21**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$72.0	-$1.2	-$9.7	$21.5
Gold	$1 780.2	-$4.4	-$44.0	-$118.1
Equity Market Indices	**06-Dec-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	4 538	-1.22	-3.39	20.83
EuroStoxx 50	4 106	-0.08	-5.88	15.59
CAC 40	6 820	0.65	-3.13	22.86
Nikkei 225	27 927	-1.26	-5.69	1.76
Shanghai Composite	3 589	0.75	2.80	3.35
VIX - Implied Volatility Index	29.79	29.75	80.76	30.95

Source: Bloomberg, Ostrum Asset Management

Additional notes

Ostrum Asset Management

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