

Insight

By Esty Dwek, Head of Global Market Strategy, Natixis Investment Managers Solutions

Reflation does not equal inflation

With ultra-accommodative monetary policy, trillions in QE programs and trillions more in fiscal stimulus measures, there is so much money ‘out there’ that it *must* eventually lead to inflation, right? Admittedly, the risks are skewed to the upside, particularly since the Democrats won both Georgia run-off races to give President Biden the razor-thin majority he needs to get his fiscal packages through Congress. That said, we still do not expect an inflation scare this year, even if inflation is bound to rise, and we certainly do not expect the Federal Reserve (Fed) to “blink” and reign in supportive policies much sooner than anticipated.

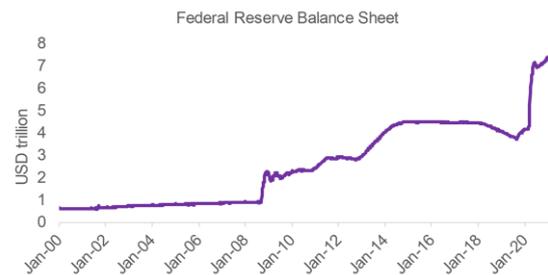
Why does inflation matter?

With all the headlines and debate about the future path of inflation, one might forget why the end result matters so much. Ultimately, it is about the Fed and about financing costs for businesses (aka yields). If we start to see sustained high inflation, yields will surge, and the Fed will need to step in and withdraw accommodative monetary policies. Today, the Fed has indicated that interest rates will remain at zero until 2023 and that QE will remain in place until “substantial progress has been made on maximum-employment and average inflation goals”. If inflation rises too quickly, the Fed will need to backtrack on its guidance and raise interest rates sooner. As such, the fear is of a spike in yields, another taper tantrum, and a sharp sell-off in equities.

Indeed, equity markets tend to do well with moderately rising inflation. However, yield spikes or unexpected Fed tightening have not been supportive for risk assets. Of course, the most at-risk segment is the bond market, with extremely low starting yields and the perception that these can only go in one direction – up. In our view, as long as the rise is gradual, equity markets can continue to do well. However, unruly moves would certainly hurt investor sentiment.

One could debate inflation globally, but US inflation is more likely to move higher and the Fed is the biggest mover of markets, since so many assets are priced off Treasuries. Moreover, in Europe, disinflation remains a bigger concern despite the jump in January inflation measures, and the question for the European Central Bank (ECB) is more about additional support than withdrawing extraordinary measures.

Balance sheet expansion to continue



Source: Bloomberg, Fed, Natixis IM Solutions, 9 February 2021

Upside risks

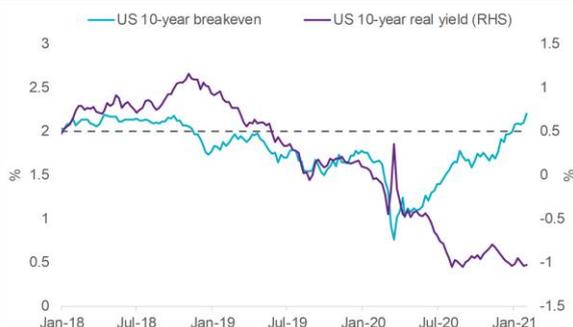
While we believe that most of the fiscal measures are acting as income replacement and the still-low velocity of money suggests inflation is not about to pick up meaningfully, the possibility cannot be excluded. Indeed, the Fed “wants” to be behind the curve with its new average inflation targeting mechanism, so inflation is set to be higher in the coming years, as the Fed allows it to rise further before acting.

Inflation expectations have steadily risen since vaccine day, with an added boost in January from the Democrats’ surprise majority in the Senate. With trillions more expected in fiscal spending and an economy that is already recovering, overheating could happen. Indeed, the economic disruption has been concentrated to certain sectors, which could see a rapid rebound once vaccines are broadly distributed. In addition, wage growth hasn’t fallen outside of these

Reflation does not equal inflation

affected sectors, so a tightening labour market could lead to wage pressures.

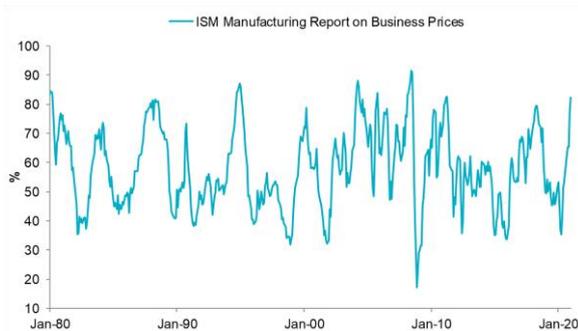
Inflation expectations have moved up



Source: Bloomberg, Natixis IM Solutions, 9 February 2021

Pre-pandemic, services inflation was relatively sticky around 3%; it was the disinflationary trend on the goods side that kept the overall CPI figure in check. However, with supply chain disruptions, rising transportation costs and higher commodity prices, goods inflation could climb. Indeed, we have already seen a rise in the prices paid by manufacturers. The question is whether these will combine with higher services prices for higher headline CPI.

Goods inflation could pick up



Source: Bloomberg, Natixis IM Solutions, 9 February 2021

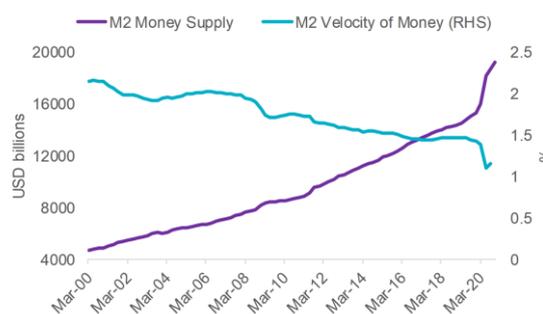
Further out, the question of repatriation of strategic industries and of de-globalisation remains. Indeed, even if Biden is more multilateralist than Trump was, we are unlikely to go back to the era of unbridled globalisation. Moreover, with shortages of masks, medical equipment and more, many industries deemed strategic are set to be repatriated over the coming years, often at a higher cost with local manufacturing. As such, higher prices are likely to materialise, but in a gradual manner over many years.

This time is not different

While we have had massive QE programs since the last financial crisis, none were on the scale seen

today. Combined, the Fed, the ECB, the Bank of Japan and the Bank of England have grown their balance sheets by more than 20% of their combined GDP since the pandemic began a year ago, a scale incomparable to 2009. Moreover, broad money measures, which include household bank balances, have too. And lending to the private sector has risen as firms have borrowed heavily to continue operations despite disruptions. As such, the broad money supply has skyrocketed. Nonetheless, the velocity of money hasn't moved.

Still no pick up in the velocity of money



Source: Bloomberg, Natixis IM Solutions, 9 February 2021

The Cares Act left US households with USD1.5 trillion in excess savings in 2020 – the equivalent of 10% of annual consumption – and that is before the Cares Act II and President Biden's recent proposals. Combined, these could inject an additional USD300 billion per month into the economy through the end of September. In November (pre-Cares Act II), Americans' total after-tax income was 4.3% higher than a year ago. For now, Americans do not have the opportunity to spend, suggesting this cushion will remain until economies reopen, which will then lead to a massive spending spree.

However, Americans were already shifting consumption online before the pandemic, which has only accelerated this trend. As such, it is mostly the services sector that has suffered. Indeed, while consumer spending has been down overall, retail spending on goods has been much higher, which suggest only limited potential for overheating with reopening. Moreover, even if we do see all the pent-up demand deployed simultaneously, it is likely to prove temporary.

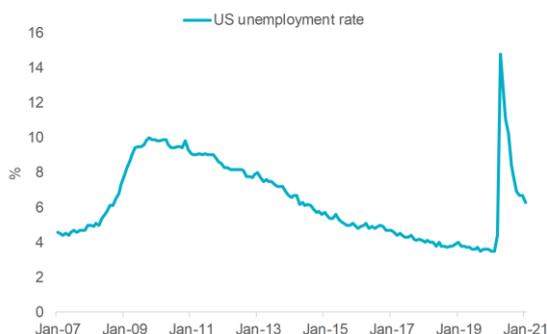
Slack and unemployment

Spending is set to pick up, that is a given. However, with ongoing high unemployment and slack in the economy, even a reopening spending boom is unlikely to spur inflation, particularly not on a sustained basis.

Reflation does not equal inflation

Indeed, the labour market is set to take years to recover, with unemployment not expected to fall back to 4% before 2022 or 2023. In addition, permanent unemployment has risen as a result of the pandemic as a number of jobs, especially in the services sectors, are not likely to be recovered. As such, slack in the labour market suggests prices cannot rise that much. Indeed, with so many workers on the sidelines, does the services sector have much pricing power?

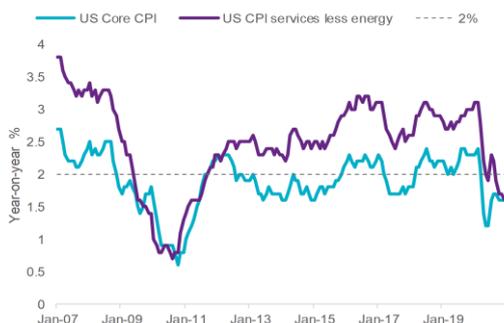
The labour market will be slow to recover



Source: Bloomberg, Natixis IM Solutions, 9 February 2021

Headline CPI is likely to rise above 2% in the coming months as base effects over the spring of 2020 lead to a technical, transitory, bounce in inflation. However, core measures tend to follow the services component, which is only likely to rise as the labour market tightens. A slow labour market recovery should act as a cap on core inflation measures.

Tough for core inflation to rise without services inflation



Source: Bloomberg, Natixis IM Solutions, 9 February 2021

Moreover, delays in vaccination, logistical disruptions with vaccine deliveries and worries about new variants suggest the global economy will not simultaneously reopen in one fell swoop. This could also be the case across different US states. This suggests we are unlikely to see significant overheating, or at least not ongoing overheating.

Finally, a technicality of the inflation expectations (breakeven) market suggest inflation is not about to

surge. Indeed, TIPS (Treasury Inflation-Protected Securities) are used as a proxy for inflation expectations but the liquidity premium in the TIPS market suggests that it is this premium that is moving rather than actual inflation expectations.

Overall, we expect inflation to rise due to base effects and massive fiscal spending with pent up demand unleashed with the reopening of economies, but we believe this will prove only temporary. The Fed has already stated it wouldn't (over-)react and yields should therefore remain somewhat contained.

Positioning for a possibility

While we do not expect a big move in inflation this year, the reflation trade is set to continue to gather steam with vaccine deployment and massive fiscal spending by the Biden administration. Yields are likely to rise further and the catch-up of cyclical sectors should continue.

In this context, fixed income is set to suffer the most, especially on the sovereign debt side. While we have focused on the US, European yields are likely to rise in sympathy, even if to a lesser extent. Credit spreads have tightened sharply already, but they still have room to absorb some higher yields, making us more comfortable with credit risk than interest rate risk.

Equity markets should continue to do well as long as yields do not spike and the Fed remains on hold – our base case. Indeed, already rich valuations would further deteriorate with higher rates. Conversely, nominal earnings grow with inflation and higher inflation would be due to stronger growth, a positive for risk assets as long as monetary policy remains accommodative. Such reflation would support cyclical sectors such as energy and financials.

Commodities would be beneficiaries of an inflationary cycle, but they can still continue to recover without high core inflation as economies reopen and demand picks up. They tend to act as good diversifiers in portfolios, as would inflation-protected TIPS and gold, which both have a place in portfolios in a reflationary scenario. Indeed, real rates are set to remain low or negative with the short end of the yield curve anchored by the Fed and rising inflation pushing real yields lower.

This material has been provided for information purposes only to investment service providers or other Professional Clients, Qualified or Institutional Investors and, when required by local regulation, only at their written request. This material must not be used with Retail Investors.

In the E.U. (outside of the UK and France): Provided by Natixis Investment Managers S.A. or one of its branch offices listed below. Natixis Investment Managers S.A. is a Luxembourg management company that is authorized by the Commission de Surveillance du Secteur Financier and is incorporated under Luxembourg laws and registered under n. B 115843. Registered office of Natixis Investment Managers S.A.: 2, rue Jean Monnet, L-2180 Luxembourg, Grand Duchy of Luxembourg. **Italy:** Natixis Investment Managers S.A., Succursale Italiana (Bank of Italy Register of Italian Asset Management Companies no 23458.3). Registered office: Via San Clemente 1, 20122 Milan, Italy. **Germany:** Natixis Investment Managers S.A., Zweigniederlassung Deutschland (Registration number: HRB 88541). Registered office: Im Trutz Frankfurt 55, Westend Carrée, 7. Floor, Frankfurt am Main 60322, Germany. **Netherlands:** Natixis Investment Managers, Netherlands (Registration number 50774670). Registered office: Stadsplateau 7, 3521AZ Utrecht, the Netherlands. **Sweden:** Natixis Investment Managers, Nordics Filial (Registration number 516405-9601 - Swedish Companies Registration Office). Registered office: Kungsgatan 48 5tr, Stockholm 111 35, Sweden. **Spain:** Natixis Investment Managers, Sucursal en España. Serrano nº90, 6th Floor, 28006, Madrid, Spain. **Belgium:** Natixis Investment Managers S.A., Belgian Branch, Gare Maritime, Rue Picard 7, Bte 100, 1000 Bruxelles, Belgium.

In France: Provided by Natixis Investment Managers International – a portfolio management company authorized by the Autorité des Marchés Financiers (French Financial Markets Authority - AMF) under no. GP 90-009, and a public limited company (société anonyme) registered in the Paris Trade and Companies Register under no. 329 450 738. Registered office: 43 avenue Pierre Mendès France, 75013 Paris.

In Switzerland: Provided for information purposes only by Natixis Investment Managers, Switzerland Sàrl, Rue du Vieux Collège 10, 1204 Geneva, Switzerland or its representative office in Zurich, Schweizergasse 6, 8001 Zürich.

In the British Isles: Provided by Natixis Investment Managers UK Limited which is authorised and regulated by the UK Financial Conduct Authority (register no. 190258) - registered office: Natixis Investment Managers UK Limited, One Carter Lane, London, EC4V 5ER. When permitted, the distribution of this material is intended to be made to persons as described as follows: **in the United Kingdom:** this material is intended to be communicated to and/or directed at investment professionals and professional investors only; **in Ireland:** this material is intended to be communicated to and/or directed at professional investors only; **in Guernsey:** this material is intended to be communicated to and/or directed at only financial services providers which hold a license from the Guernsey Financial Services Commission; **in Jersey:** this material is intended to be communicated to and/or directed at professional investors only; **in the Isle of Man:** this material is intended to be communicated to and/or directed at only financial services providers which hold a license from the Isle of Man Financial Services Authority or insurers authorised under section 8 of the Insurance Act 2008.

In the DIFC: Provided in and from the DIFC financial district by Natixis Investment Managers Middle East (DIFC Branch) which is regulated by the DFSA. Related financial products or services are only available to persons who have sufficient financial experience and understanding to participate in financial markets within the DIFC, and qualify as Professional Clients or Market Counterparties as defined by the DFSA. No other Person should act upon this material. Registered office: Unit L10-02, Level 10, ICD Brookfield Place, DIFC, PO Box 506752, Dubai, United Arab Emirates

In Japan: Provided by Natixis Investment Managers Japan Co., Ltd. Registration No.: Director-General of the Kanto Local Financial Bureau (kinsho) No.425. Content of Business: The Company conducts investment management business, investment advisory and agency business and Type II Financial Instruments Business as a Financial Instruments Business Operator.

In Taiwan: Provided by Natixis Investment Managers Securities Investment Consulting (Taipei) Co., Ltd., a Securities Investment Consulting Enterprise regulated by the Financial Supervisory Commission of the R.O.C. Registered address: 34F., No. 68, Sec. 5, Zhongxiao East Road, Xinyi Dist., Taipei City 11065, Taiwan (R.O.C.), license number 2020 FSC SICE No. 025, Tel. +886 2 8789 2788.

In Singapore: Provided by Natixis Investment Managers Singapore Limited (company registration no. 199801044D) to distributors and institutional investors for informational purposes only.

In Hong Kong: Provided by Natixis Investment Managers Hong Kong Limited to institutional/ corporate professional investors only.

In Australia: Provided by Natixis Investment Managers Australia Pty Limited (ABN 60 088 786 289) (AFSL No. 246830) and is intended for the general information of financial advisers and wholesale clients only.

In New Zealand: This document is intended for the general information of New Zealand wholesale investors only and does not constitute financial advice. This is not a regulated offer for the purposes of the Financial Markets Conduct Act 2013 (FMCA) and is only available to New Zealand investors who have certified that they meet the requirements in the FMCA for wholesale investors. Natixis Investment Managers Australia Pty Limited is not a registered financial service provider in New Zealand.

In Latin America: Provided by Natixis Investment Managers S.A.

In Uruguay: Provided by Natixis Investment Managers Uruguay S.A., a duly registered investment advisor, authorised and supervised by the Central Bank of Uruguay. Office: San Lucar 1491, Montevideo, Uruguay, CP 11500. The sale or offer of any units of a fund qualifies as a private placement pursuant to section 2 of Uruguayan law 18,627.

In Colombia: Provided by Natixis Investment Managers S.A. Oficina de Representación (Colombia) to professional clients for informational purposes only as permitted under Decree 2555 of 2010. Any products, services or investments referred to herein are rendered exclusively outside of Colombia. This material does not constitute a public offering in Colombia and is addressed to less than 100 specifically identified investors.

In Mexico: Provided by Natixis IM Mexico, S. de R.L. de C.V., which is not a regulated financial entity, securities intermediary, or an investment manager in terms of the Mexican Securities Market Law (Ley del Mercado de Valores) and is not registered with the Comisión Nacional Bancaria y de Valores (CNBV) or any other Mexican authority. Any products, services or investments referred to herein that require authorization or license are rendered exclusively outside of Mexico. While shares of certain ETFs may be listed in the Sistema Internacional de Cotizaciones (SIC), such listing does not represent a public offering of securities in Mexico, and therefore the accuracy of this information has not been confirmed by the CNBV. Natixis Investment Managers is an entity organized under the laws of France and is not authorized by or registered with the CNBV or any other Mexican authority. Any reference contained herein to "Investment Managers" is made to Natixis Investment Managers and/or any of its investment management subsidiaries, which are also not authorized by or registered with the CNBV or any other Mexican authority.

The above referenced entities are business development units of Natixis Investment Managers, the holding company of a diverse line-up of specialised investment management and distribution entities worldwide. The investment management subsidiaries of Natixis Investment Managers conduct any regulated activities only in and from the jurisdictions in which they are licensed or authorized. Their services and the products they manage are not available to all investors in all jurisdictions. It is the responsibility of each investment service provider to ensure that the offering or sale of fund shares or third party investment services to its clients complies with the relevant national law.

The provision of this material and/or reference to specific securities, sectors, or markets within this material does not constitute investment advice, or a recommendation or an offer to buy or to sell any security, or an offer of any regulated financial activity. Investors should consider the investment objectives, risks and expenses of any investment carefully before investing. The analyses, opinions, and certain of the investment themes and processes referenced herein represent the views of the portfolio manager(s) as of the date indicated. These, as well as the portfolio holdings and characteristics shown, are subject to change. There can be no assurance that developments will transpire as may be forecasted in this material. The analyses and opinions expressed by external third parties are independent and does not necessarily reflect those of Natixis Investment Managers. Past performance information presented is not indicative of future performance.

Although Natixis Investment Managers believes the information provided in this material to be reliable, including that from third party sources, it does not guarantee the accuracy, adequacy, or completeness of such information. This material may not be distributed, published, or reproduced, in whole or in part. All amounts shown are expressed in USD unless otherwise indicated.

NATIXIS INVESTMENT MANAGERS

RCS Paris 453 952 681 - Capital : €178 251 690
43, Avenue Pierre Mendès-France, 75013 Paris
www.im.natixis.com

NATIXIS INVESTMENT MANAGERS INTERNATIONAL

Limited company with a share capital of 51 371 060.28 euros
Trade register n° 329 450 738 Paris Authorized by the Autorité des Marchés Financiers (French Financial Markets Authority - AMF) under no. GP 90-009.
Registered office: 43, avenue Pierre Mendès-France - 75013 Paris
www.im.natixis.com