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## ● Topic of the week: The return of inflation?

- A rapid progression of monetary aggregate is one of many elements that could push inflation on a higher path
- This scenario is absolutely not priced nor expected by the markets and could trigger sizeable movements, especially for the curve.

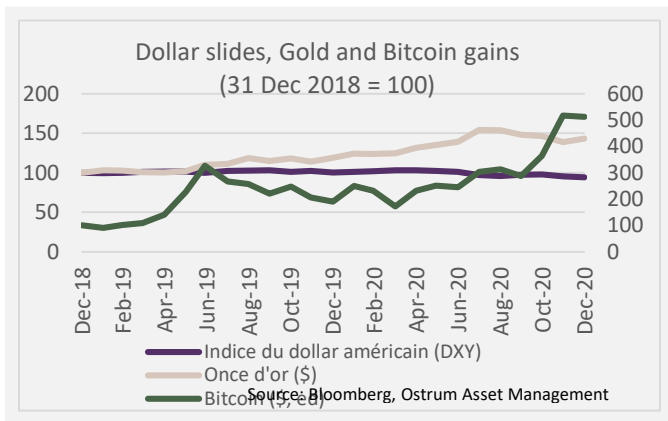
## ● Brexit : The moment of truth

- Time is running out and divergences are strong increasing the uncertainty and the risk of a hard Brexit
- Significant disruptions from January 1, even with an agreement
- Considerable impact on British growth of a hard Brexit

## ● Market review: Casting doubt

- ECB further easing expected this week
- US fiscal deal could be signed this week
- Dollar slide continues
- Rich valuations in high yield space

### Chart of the week



Currency is an accounting unit, a medium of exchange and a store of value. CBs have monopoly power over money issuance, which intrinsic value is tied to high-quality collateral. Purchases of risky debt securities may have undermined the intrinsic value of currency. The implied devaluation (for instance the US dollar) sparked a reach for alternatives. Whilst gold (+43% since 2018) is a well-established store of value, it cannot be used as a means of transaction. Bitcoin (up 402%) is too volatile to be used as store of value but may be used to clear a reduced number of transactions. Both asset values rest mainly on their relative scarcity.

## ● Figure of the week

**100**

Source : Ostrum AM

100 trillion USD. At the end of last week the world market capitalization past that mark for the first time ever according to the Bloomberg estimate. That is a 15% increase since the beginning of the year.



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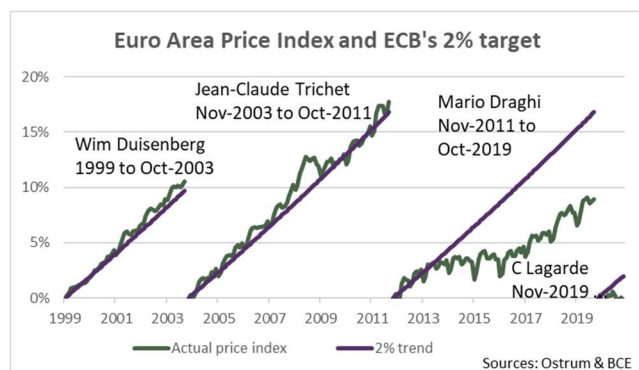
• Topic of the week

## The return of inflation?

The rapid acceleration of money aggregates could put inflation on a higher path over the medium term. This scenario is absolutely not priced nor expected by the markets and could trigger sizeable movements, especially for the curve.

## We're far from it

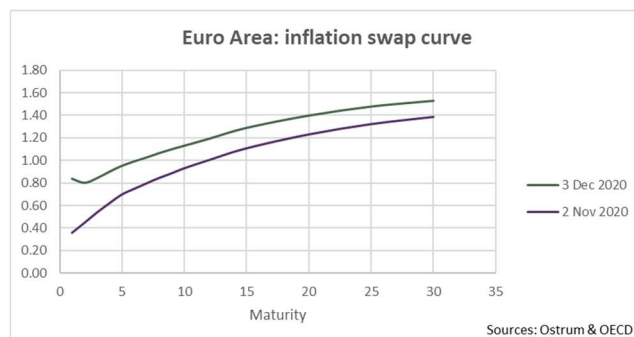
Return of inflation? The question might sound misplaced, **European inflation for almost a decade has clearly been too low compared to ECB's target at 2%.**



Recent data are not encouraging. The November inflation numbers published last week was a -0,2% while core inflation was at 0,2%, unchanged compared to the previous month which suggests that the collapse in inflation might not be as temporary as previously thought. Of course, part of the recent decline owes much to the Covid crisis and is likely to be reverted in the foreseeable future. Inflation would then trend back up, for instance, the energy component was down 8,4% in November but could print a +15 to +20% in Q2 next year if oil prices stay where they are now.

However, a rebound is bound to be most and medium-term inflation prospects remain mediocre at best. **The ECB, as well as the Fed, have inflation forecasts that are below their stated objectives.** The ECB expects inflation at 1.3% in 2020, too low compared to the 2% target meanwhile the Fed sees inflation barely reaching 2.0% in 2023, again below the target of an inflation that overshoots the 2% mark.

Finally, it is worth underlying that markets think alike with a sobering inflation outlook even though market expectations have been trending steadily up over the past month.

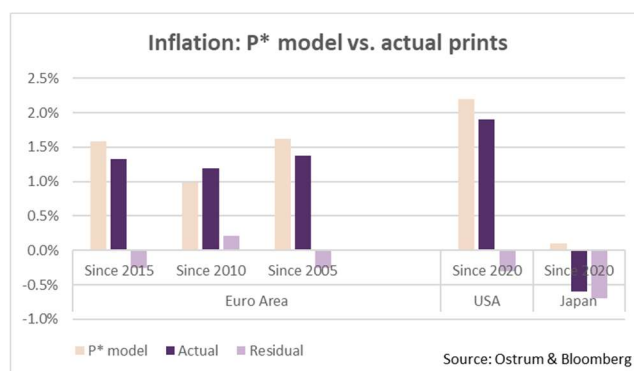


Against those evidences, it seems to us, however, that one should not underestimate the likelihood of a more pronounced inflation trend.

## A long term approach

Our argument is daring (or foolish) as it is based on the monetarist theory of inflation which has been abundantly mocked and ridiculed of late. The skyrocketing central bank's balance sheet appears to be clearly at odds with the stubbornly low inflation prints.

Yet the theory remains empirically accurate: **money aggregate growth is consistent with inflation numbers over a long period of time.** If we turn our attention to the Euro Zone, the theory would be consistent with an average annual of 1.0% over the past decade while the GDP deflator has gained 1.2% on average over the period. Not bad at all ! Since 2005 (unfortunately the necessary details are not available before that point) the model tells 1.6% while the reality was 1.4%. That's a level of precision many economists would kill for!



Is that cheer luck? Maybe. It is however important to underline that the model performs equally well in the USA and in Japan. Since 2000, the approach concludes to 2.2% inflation in the USA while the actual print is 1.9%. In Japan the order of magnitude is also reasonable with a +0.1% forecast vs. a -0.6% actual number for inflation, again sicken 2000.

**Conclusion:** it would not be appropriated to put that approach in the bin. Over a long period, we are talking decades not months, there's no obvious proof that the link between money creation and inflation has been broken. On the contrary.

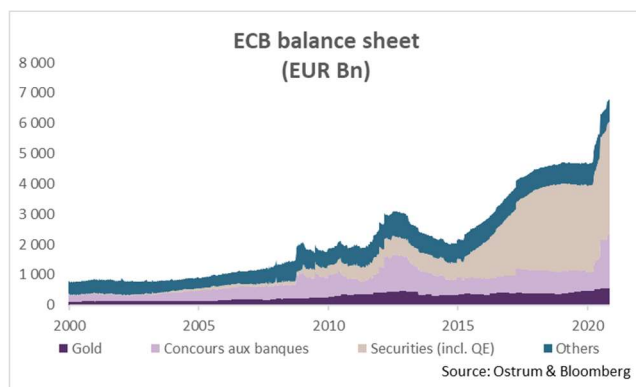
## A bit of theory

To understand the intuition behind this approach, imagine that the money available in an economy doubles but that production does not change, eventually prices will have to adjust and will double. To be more precise, the below is the canonical equation for this theory:

$$P.Y = M.V$$

Nominal production (P is the price level, Y the volume of production) has to equate the monetary base (M) adjusted for the velocity of money (V).

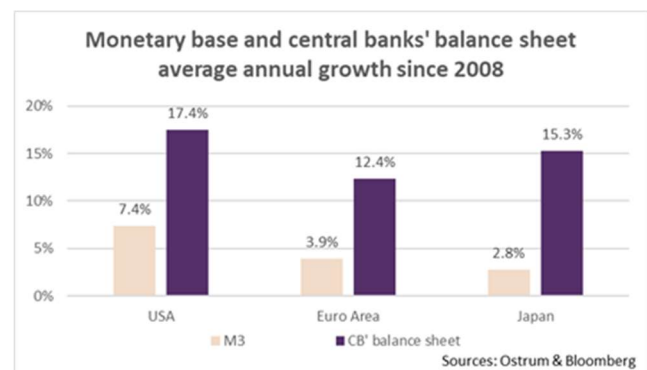
Lately, this theory has been copiously ridiculed. The size of central banks' balance sheets has ballooned over the past decade or so while inflation, as noted above, has remained very disappointing. As a reminder the Fed's balance sheet moved from 1 Trillion in 2008 to about 7.1 lately, this is on average a 17% annual increase over the period, over three times faster than the corresponding increase in nominal GDP. On that dimension, the ECB has no reason to be ashamed with a balance sheet size that moved from 1.3 trillion euros to 6.7 trillion, a 421% increase, or 14% per annum.



**However, what really matters for inflation is not the ECB's balance sheet size but the volume of liquidity available for transactions.** Of course, these two aggregates are linked and tend to move in tandem. However, the proverbial "printing press" is a very misleading image. In modern economies, transaction money is not created by central banks but by commercial banks when they grant credit. This, in economists' parlance is called "the counterparty of M3": when a bank grants a loan it will appear

on the asset side of its balance sheet and it will credit the current account of the customer. This increases the money aggregates. Part of these liquidities are refinanced at the central bank, hence the usual link between central bank's balance sheet and M3.

But during the last decade the two aggregates have diverged. Why? The ECB has indeed provided vast amount of liquidity to the banking system but those liquidities, to a very large extent, have been deposited back at the ECB for precautionary reasons but also for regulatory reasons. As a result, M3, which measures transaction liquidities, has been very pedestrian. **Those liquidities created by the ECB have been, to use economists' jargon "sterilized".**



## The return of inflation?

The issue is that, while monetary aggregates have been very sluggish over the past decade, they have neatly accelerated since the beginning of this year. Indeed, **credit granted by European banks during the pandemic have increased at an unusually rapid pace.** This owes much to the state guarantees but also to the extremely loose monetary policy implemented. The consequence has been a sharp acceleration in Europe, as well as in the USA, of monetary aggregates.



This will not lead to a rapid increase in inflation. Monetary mechanisms are slow to feed through and gradual in their effects. Moreover, the output gap remains wide and will help

maintain inflationary pressure at bay during the next few quarters as there is absolutely no signs of supply/demand imbalance yet. It is nevertheless reasonable to assume that, over the longer term, the average level of inflation could be higher than what it had been over the last decade or so.

**A European inflation that averages more than 2% over the cycle, or even above 3%, seems to become a plausible hypothesis.**

## Markets are not reaped

That inflation dynamic might seem modest after all. And indeed, this is far from a double-digit 1980s style inflation trajectory. We would argue however that this can be largely enough to trigger significant market rotation.

**The issue is that the market is not in line at all with this scenario.** It does not believe it at all, even if it is worth noting that markets inflation expectations have trended upwards on both sides of the Atlantic. Inflation swap in Europe are still very low, the 30-year is current at a very pale 1.5% (it was 0.9% in March!).



*Markets are not  
prepared for a return  
of inflation*

half of the past decade and is now saying that even on a 30-year horizon, inflation will be comfortably below the 2% mark.

The market does not believe at all in the return of inflation. And it is an issue in terms of the ECB's credibility. The Fed, by contrast, is in a better place as 1-year swap spreads in

four years is currently at 2.06%. The market gives the benefit of the doubt to the Fed with a return of inflation in the not that distant future.



**An additional symptom of the market unpreparedness is the reaction of inflationary surprises.** The Bund reaction to inflationary surprises has been unusually strong in the recent past. Of course, surprises are currently inconsequential hence the curve moves are also quite limited. But this high sensitivity of the curve suggests that even a moderated inflation scenario, such as the one we introduced above, could result in substantial curve adjustments.



## Conclusion : stay prudent!

Consequences of the current crisis are far from obvious. If the short-term effects are indisputably deflationary, the reverse might be true over the longer term. The rapid progression of monetary aggregate is one of many elements that could push inflation on a higher path than the one we've been accustomed over the past two decades.

However, markets do not believe at all in this scenario. This could lead to hasty repricing. Not only for the curve but also for related asset classes. One can especially think of higher volatility and a rotation in the equity market.

**Stéphane Déo**



## Brexit: The moment of truth

**Brexit will take place on December 31 at midnight with or without a deal. Strong divergences and the very short time to reach an agreement increase the uncertainty and the risk of a hard Brexit.**

### It's urgent to find a deal

UK officially left the European Union on January 31, 2020 at midnight. A period of transition then began during which relations remained unchanged with the aim of reaching a trade deal. Boris Johnson has decided not to extend it and, on December 31 at midnight, Brexit will actually take place with or without a trade deal.

Negotiations are in their final stretch before the European Council on December 10 and 11. Divergences between the United Kingdom (UK) and the European Union (EU) remain strong. They relate to three points: fishing (access conditions to British waters), conditions of fair competition, in particular as regards State aid, and governance : mechanism for settling disputes in the context of a possible trade deal. The British government insists on the need to regain its sovereignty and regain control when the EU doesn't want a deal at any cost.

As this week turns out to be decisive, Boris Johnson is once again bringing the highly controversial UK internal market bill to the House of Commons. It partly returns to the divorce agreement signed between London and Brussels and in particular to the Irish protocol intended to avoid the appearance of a physical border between Ireland and Northern Ireland, whatever the terms of exit from UE. These provisions aim to preserve the Good Friday agreement that ended 30 years of civil war. This bill was strongly

condemned domestically and internationally and rejected by the UK upper House. The EU has launched legal proceedings against the UK and said it will not sign a deal if the divorce Treaty is not respected.

The British government also wants to introduce a tax bill on Wednesday that also goes against the

Irish protocol. Tensions between London and Brussels will therefore increase at a crucial point in the negotiations.

*Time is running out to find an agreement and limit the impact on growth, which will be significant in any case*

## Strong disruptions are to be expected even in the event of an agreement

On December 31st at midnight, the UK will exit the single market and the European customs union, implying a loss of fluidity in the trade of goods and services and ending the free movement of people, with its main trading partner. Border controls will then be introduced, generating additional costs and increased delivery times. The Covid-19 epidemic has also delayed preparations for Brexit, in particular with regard to the mechanism to comply with the Irish protocol. The National Audit Office has signaled that trade relations between UK and EU will experience serious disruption from January 1, with significant risks to the arrangement to comply with the Irish protocol.

## Strong impact of Brexit on growth

Brexit will take place as the British economy is one of the most affected by the Covid-19 crisis. The UK experienced its deepest recession in just over 300 years in the first half of the year and is facing a second wave of the epidemic. The Office for Budget Responsibility has just released a report. Its conclusions are in line with the average of previous studies carried out. A Brexit with a trade deal has an estimated impact of -4% on average on long term UK growth. A Brexit without a trade deal (« hard Brexit ») weighs 6% on it in the long term. In the short term, in the event of a hard Brexit, GDP would contract by an additional 2%.

Without a trade deal, trade will be subject to the rules of the World Trade Organization, which will result in increased tariffs and non-tariff barriers. This will particularly penalize sectors that were relatively less affected during the Covid-19 crisis. To the rise in customs tariffs will be added a marked depreciation of the pound which will result in higher inflation likely to weigh on the purchasing power of households. In the long term, potential growth will be affected by lower productivity, linked to the decline in foreign direct investment and lower trade, and lower growth in the working population, following lower migratory flows from the European Union.

Time is running out to find an agreement and limit the impact on growth, which will be significant in any case.

**Aline Goupil-Raguènes**  
Developed Countries Strategist

## • Market review

# The shadow of a doubt

**The end of the year is usually favorable to risky assets and this year, however very unusual, is no exception. The outperformance of equity and credit markets appears fueled by the dollar's fall, which is the distinctive feature of the reflation trade across financial markets**

In a three-speed world, Asia is well ahead in this cycle. The Chinese economy has been on a solid growth path since last spring. The yuan is gradually appreciating (6,53 vs. the US dollar) pulling most Asian currencies in its path. The move away from a dollar-dominated world to a yuan-based one is still remote, but the yuan may gain importance much faster than the 2030 deadline for full convertibility would suggest. Across the Pacific, the US has, as always, chosen economic growth over public health considerations, as the pandemic situation appears out of control. ISM surveys still point to an economic expansion but the deterioration of the sanitary backdrop will undoubtedly weigh on activity in months ahead. Employment is still growing at a solid pace with 344k new private-sector jobs added in November. Unemployment rate has dipped below 7% after a peak near 14% at the start of the pandemic. A fiscal plan worth \$908b may be adopted by the US Congress. The House Democrats' proposal includes \$160b funding for local governments, \$180b for federal unemployment benefit schemes and \$288b to maintain the Paycheck Protection Program along with bailout funds for the transport (airlines) industry hit hardest by the pandemic. The Europe is treading water as political shenanigans threatening the adoption of the multi-year EU budget, including the €750b recovery fund. Poland and Hungary have maintained their vetoes on the budget agreement just a few days as the EU summit looms later this week. In parallel, Brexit negotiations appear to be going nowhere although an 11<sup>th</sup> hour mini deal might still be possible. Against this backdrop, the ECB will have no choice this week but to ease policy further.

The heterogeneity in economic growth cycles is in stark contrast with the global reflation trade at play across world financial markets. The upturn in US yields gathered pace last week as t-note yields came close to the 1% threshold. The market may be testing the Fed's willingness to let yields drift higher. The yield curve steepened last week. Demand for mortgage credit is indeed so strong that significant paying interest is pulling rates higher. Yield targeting similar to the BoJ's experiment of yield curve control could be a way to limit balance sheet expansion whilst maintain the curve

steep. Operation twist is another possibility. The option to be chosen by Fed policymakers will also depend on the size of the fiscal stimulus to come and the Treasury's strategy to refinance outstanding Treasury bills. Ten-year breakevens rose markedly last week by a whopping 12bp to 1.90% in the wake of higher oil prices as OPEC+ struck a deal to limit output growth to 500k bpd. In the euro area, the ECB meeting is this week's market mover. The Bank may lower its growth projections and keep inflation forecasts low. The ECB will likely expand the PEPP by 300-500b over 6 to 12 months beyond the current deadline of June 2021 and may offer two additional TLTROs in the second half of 2021. The announced easing may further extend the rally in sovereign spreads. Indeed, Italian BTPs now trade within 120bp with Iberian debt yields on 10-year maturities hovering about 0%. The long peripheral bond consensus may however limit the upside from here.

We have observed a sharp richening in valuations in high yield space of late. Despite Moody's forecasts of 6% default rate over 12 months sometime next spring, speculative-grade spreads have shrunk by a further 18bp last week to 353bp. The iTraxx Crossover is indeed trading within 240bp even as the current rating composition of the CDX market index would require a spread of 249bp at the minimum to compensate investors for historical average default risk. Investment grade corporate bonds in the euro area is also rallying, especially the financial sector, in spite of ongoing outflows from credit funds. New issue premiums have been quite reduced in the latest deals. In equity market space, the energy sector (+10.4% last week) helped by the OPEC+ deal and financials pulled indices higher last week. The rebound in banking stocks is traceable to rumors hinting at the possibility to pay dividends worth 15-25% of net income next year. The banking sector supervisor (the ECB) poured some cold water on such expectations late last week but hinting at another 6-month period of reduced payouts.

**Axel Botte**

Global strategist

## What to watch for next week

- ECB : further easing measures expected.
- Brexit, EU summit and US fiscal deal.

## ● Main market indicators

| <b>G4 Government Bonds</b>         | <b>07-Dec-20</b> | <b>-1wk (bp)</b> | <b>-1m (bp)</b> | <b>YTD (bp)</b> |
|------------------------------------|------------------|------------------|-----------------|-----------------|
| EUR Bunds 2y                       | -0.76 %          | -2               | +2              | -16             |
| EUR Bunds 10y                      | -0.58%           | -1               | +4              | -40             |
| EUR Bunds 2s10s                    | 18 bp            | +0               | +2              | -24             |
| USD Treasuries 2y                  | 0.14 %           | -1               | -1              | -143            |
| USD Treasuries 10y                 | 0.93 %           | +10              | +12             | -98             |
| USD Treasuries 2s10s               | 79 bp            | +10              | +13             | +44             |
| GBP Gilt 10y                       | 0.28 %           | -2               | +1              | -54             |
| JPY JGB 10y                        | 0.02 %           | -1               | +0              | +3              |
| <b>€ Sovereign Spreads (10y)</b>   | <b>07-Dec-20</b> | <b>-1wk (bp)</b> | <b>-1m (bp)</b> | <b>YTD (bp)</b> |
| France                             | 24 bp            | 0                | -2              | -6              |
| Italy                              | 119 bp           | -1               | -7              | -41             |
| Spain                              | 64 bp            | -2               | -8              | -2              |
| <b>Inflation Break-evens (10y)</b> | <b>07-Dec-20</b> | <b>-1wk (bp)</b> | <b>-1m (bp)</b> | <b>YTD (bp)</b> |
| EUR OATi (9y)                      | 69 bp            | +10              | +28             | -               |
| USD TIPS                           | 190 bp           | +11              | +24             | +12             |
| GBP Gilt Index-Linked              | 322 bp           | +11              | +13             | +11             |
| <b>EUR Credit Indices</b>          | <b>07-Dec-20</b> | <b>-1wk (bp)</b> | <b>-1m (bp)</b> | <b>YTD (bp)</b> |
| EUR Corporate Credit OAS           | 92 bp            | -1               | -22             | -1              |
| EUR Agencies OAS                   | 41 bp            | -2               | -8              | -3              |
| EUR Securitized - Covered OAS      | 33 bp            | -2               | -5              | -9              |
| EUR Pan-European High Yield OAS    | 353 bp           | -18              | -108            | +49             |
| <b>EUR/USD CDS Indices 5y</b>      | <b>07-Dec-20</b> | <b>-1wk (bp)</b> | <b>-1m (bp)</b> | <b>YTD (bp)</b> |
| iTraxx IG                          | 47 bp            | -2               | -3              | +3              |
| iTraxx Crossover                   | 243 bp           | -22              | -51             | +37             |
| CDX IG                             | 51 bp            | 0                | 0               | +6              |
| CDX High Yield                     | 294 bp           | -11              | -34             | +14             |
| <b>Emerging Markets</b>            | <b>07-Dec-20</b> | <b>-1wk (bp)</b> | <b>-1m (bp)</b> | <b>YTD (bp)</b> |
| JPM EMBI Global Div. Spread        | 358 bp           | -20              | -52             | +67             |
| <b>Currencies</b>                  | <b>07-Dec-20</b> | <b>-1wk (%)</b>  | <b>-1m (%)</b>  | <b>YTD (%)</b>  |
| EUR/USD                            | \$1.214          | +1.55            | +2.71           | +8.1            |
| GBP/USD                            | \$1.333          | -0.18            | +1.43           | +0.5            |
| USD/JPY                            | ¥103.99          | +0.29            | +1.41           | +4.41           |
| <b>Commodity Futures</b>           | <b>07-Dec-20</b> | <b>-1wk (\$)</b> | <b>-1m (\$)</b> | <b>YTD (\$)</b> |
| Crude Brent                        | \$48.9           | \$1.0            | \$9.1           | -\$11.6         |
| Gold                               | \$1 867.5        | \$89.4           | \$5.2           | \$344.7         |
| <b>Equity Market Indices</b>       | <b>07-Dec-20</b> | <b>-1wk (%)</b>  | <b>-1m (%)</b>  | <b>YTD (%)</b>  |
| S&P 500                            | 3 697            | 2.08             | 5.35            | 14.43           |
| EuroStoxx 50                       | 3 526            | 0.96             | 10.05           | -5.85           |
| CAC 40                             | 5 567            | 0.88             | 12.22           | -6.88           |
| Nikkei 225                         | 26 547           | 0.43             | 9.14            | 12.22           |
| Shanghai Composite                 | 3 417            | 0.73             | 3.15            | 12.02           |
| VIX - Implied Volatility Index     | 21.72            | 5.59             | -12.63          | 57.62           |

Source: Bloomberg, Ostrum Asset Management

## Additional notes

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