INDOSUEZ
WEALTH MANAGEMENT

GLOBAL OUTLOOK 2022

IS INFLATION HERE TO STAY?

Architects of Wealth

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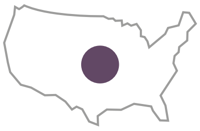
"By a continuing process of inflation, governments can confiscate, secretly and unobserved, an important part of the wealth of their citizens".
John Maynard Keynes



US inflation increased to
6.2%
on a yearly basis in November

Perspectives can shift a lot in a year!

Governments, central bank economists, and investors have swung from fearing the void created by a self-inflicted recession to fretting about the imbalances of an alarmingly rapid recovery. The global economy could stall due to supply and sourcing constraints, meaning we might have to live with (moderately) higher and less temporary-than-expected inflation.

Ironically, it is in fact the author of the "secular stagnation" theory (Larry Summers) who was among the first, earlier this year, to sound the alarm about the overheating risk posed by the *stimulus* plans in the context of an already robust recovery. Thus, the risk is that we are adopting the wrong approach, as we have done in the past, by maintaining Keynesian monetary and fiscal measures to support demand in response to a supply crisis.

INFLATION: TIME FOR A PARADIGM SHIFT?

Here as well we have a striking shift in perspective relative to the previous decade: after a decade of unsuccessful attempts to reawaken inflation expectations through asset purchase programmes that tended to push asset prices higher, the world's central banks are now seeking to reconcile support for a messy recovery with the need to normalise their monetary policies in the face of above-target inflation. They are doing all this while *de facto* having to maintain sustainable public debt. Here we are, back to the central banks' equation of the 1960s in the era of fiscal dominance. The theory of "Japanification" of the European economy is now but a distant memory!

Beyond the inflation challenges specific to this point in the cycle, economists are now hotly debating a different theory: whether or not structurally deflationary factors are still at play in our economies. For three decades, the triumvirate of ageing, globalisation and digitalisation has translated into about 1% inflation in Europe, exacerbated by the individualisation of working conditions and by oversaving and low investment. While some of these factors are expected to last (chiefly digital and demographics), it is possible that the globalisation factor and low-wage competition could recede.

NEW MARKERS TO CONSIDER

As inflation has strong political, social, and emotional dimensions, thanks to the collective memory of the European and Latin American countries that were scarred for life by hyperinflation, it makes a lot of sense that renewed price pressure would lead to overly fearful reactions to the return of uncontrolled inflation. The danger would therefore be to declare that inflation has definitively and sustainably returned, a theory to which we do not subscribe.

The most likely scenario is rather that this surge will gradually subside in 2022, and that inflation will stabilise at a higher level than in the previous decade. Ultimately, it may well be that inflation will bear the hallmarks of the social preferences and political constraints of this new decade: a keener awareness of both the unsustainability of inequality and climate change, in addition to the need to ease debt ratios without resorting to austerity policies. This equation would likely be favourable to a slightly higher inflation regime.

Prices were up
4.9%
in the Euro Area, buoyed by energy prices

The about-face is stunning here as well: low inflation policies are now seen as inegalitarian when asset prices climb, where inflation was seen as the scourge of the purchasing power of the middle class, with François Mitterrand writing in 1978 that inflation is "a tax on the poor". This is because wages have barely risen in Europe, for now, as opposed to the United States. It is therefore not clear that everyone wants inflation to come back, although it is still the best way for governments to successfully address excessive public debt.

So, it is not a new world that is emerging, but rather a new balance that needs to be found, one that is characterised by an acceleration of the trends in play before the pandemic. There is, however, one unknown that could derail the equation: the trajectory of the Chinese economy, which has been the lifeblood of global growth for the last decade and will likely be affected by the restructuring of the real estate sector for the next two years.

The central banks will therefore have to walk a tightrope between economic support, inflation control, and debt containment. Responses will vary between the western economies, which are tentatively normalising; China, which must deleverage its real estate sector; and other emerging countries, which have been the first to raise their rates. This monetary divergence is key to analysing the currency environment next year.

PRICING POWER: A TOOL AGAINST RISING PRICES

These inflationary tensions, whether lasting or temporary, pose many challenges for companies. However, for now, margin levels in various sectors of the economy are almost shamelessly resilient as we approach the end of the year. In the face of rising energy costs and higher wages in the United States, companies are currently enjoying significant pricing power; this includes sectors characterised by supply/demand imbalances and high value-added sectors where demand is relatively inelastic to price changes. It is clear, however, that it is easier to absorb these cost increases in a strong growth year than in a more normal year, and this will therefore be a key issue for expected returns in the coming years.

This is the topic we will cover in this *Global Outlook*, which seeks as much to shed factual light on the various current causes of this renewed inflation, as to sketch a scenario for the coming year, and, lastly, to identify the implications for central banks, currencies and equity investors.

I wish you happy reading and an excellent new year 2022.

VINCENT MANUEL
Chief Investment Officer,
Indosuez Wealth Management

02 | Focus on inflation drivers

ENERGY PRICES: FORECASTS AND IMPLICATIONS

Soaring gas prices and skyrocketing oil prices since early 2021 have had a knock-on effect on electricity prices, causing them to more than double. At a time when the narrative of persistently higher inflation is gaining ground, the surge in energy prices is cause for concern but should fade in 2022.

Energy's contribution to inflation in the US increased from

-0.5 PP

at end-2020 to

+1.6 PP

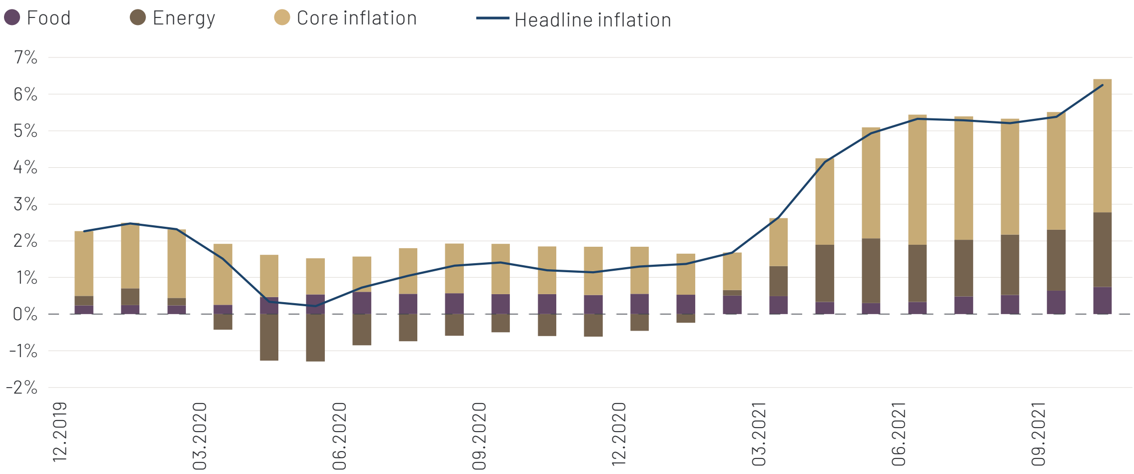
in Q3 2021

A SUPPLY-DEMAND IMBALANCE IS KEEPING HEADLINE INFLATION HIGHER

As is the case in all liberalised markets, prices result from a balance between supply and demand. Over the last 12 months, however, this balance on the energy markets has been upended. On the one hand, there is abundant demand due to the strength of the economic recovery.

On the other, supply remains limited, whether intentionally or otherwise, thereby fuelling inflationary pressures on most commodities. These have therefore pushed headline inflation higher: the contribution of the energy component to the inflation figure in the United States thus increased from -0.5 pp at end-2020 to about +1.6 pp in the third quarter of 2021 (Chart 1). The +0.4 pp estimated spill-over effect to core inflation also needs to be considered.

CHART 1: CONTRIBUTION TO US HEADLINE INFLATION BY COMPONENT, YOY, %



Source: Bloomberg, Indosuez Wealth Management.

THE OIL DEFICIT, currently estimated at **1 MBPD**, could last until spring 2022

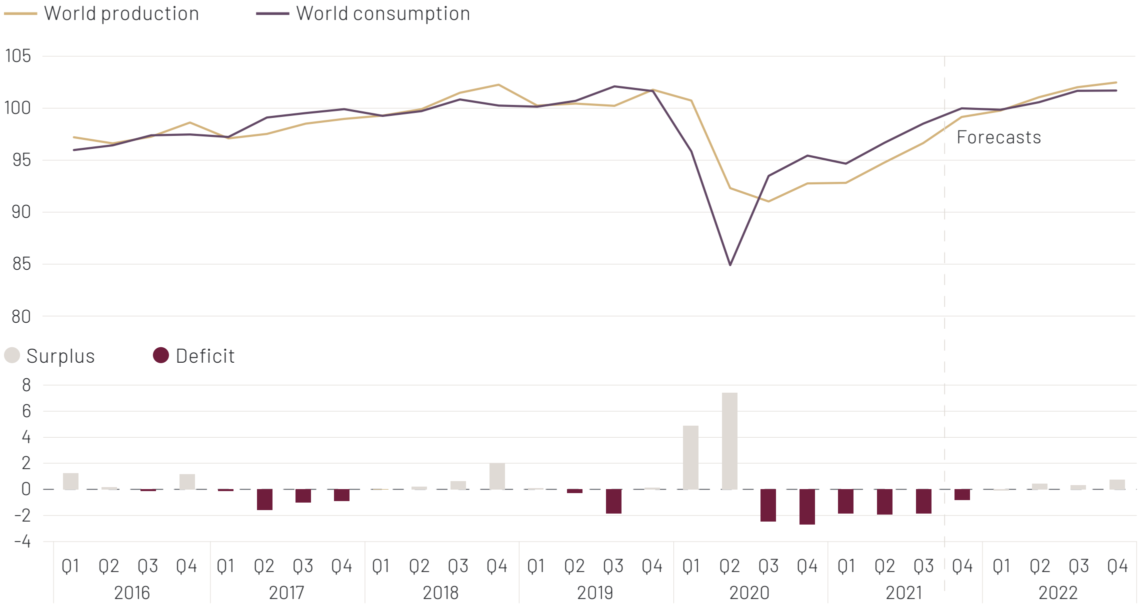
REVERSING THE PRESSURES COULD PROVE CHALLENGING IN THE VERY SHORT TERM

Energy consumption is expected to remain high this winter in Europe, and the Chinese authorities have ordered the energy sector to secure sufficient supply at all costs. Meanwhile, OPEC+ continues to ignore western governments' calls to further ramp up oil production and intends to stick to its plan to boost its supply by only 400'000 barrels per day (bpd) each month.

Left unchanged, the oil deficit – currently estimated at 1'000'000 bpd – could last until spring 2022 (Chart 2).

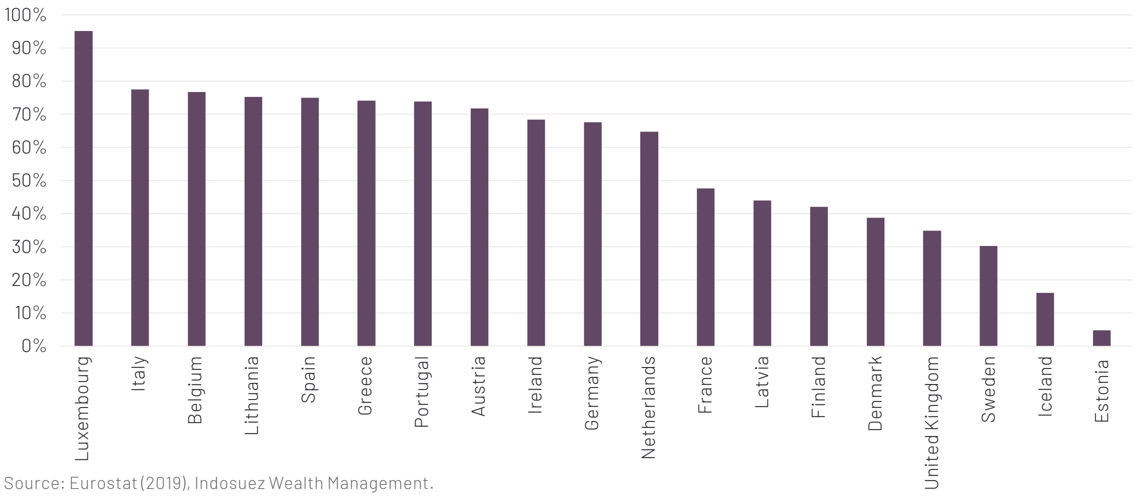
In Europe, the natural gas price trend will be dictated, in part, by resolutions to the debate around the controversial Russian Nord Stream 2 pipeline and to the geopolitical tensions between Algeria and Morocco. One thing is certain: the inflationary risk is the greatest in the short term in countries with a high energy dependence rate (Chart 3) and a significant share of fossil fuels in their energy mix.

CHART 2: WORLD OIL AND LIQUID FUELS PRODUCTION AND CONSUMPTION, MBPD



Source: US Energy Information Administration, Short-Term Energy Outlook, October 2021, Indosuez Wealth Management.

CHART 3: ENERGY DEPENDENCE OF EU COUNTRIES, %

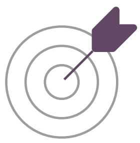


Source: Eurostat (2019), Indosuez Wealth Management.

ENERGY PRICE MOMENTUM COULD WANE IN THE SPRING

A very gradual easing of the inflationary pressures on energy prices is nevertheless expected by mid-2022: a growth normalisation in developed countries and a slowdown in China's economy could help rebalance prices, as we have already seen with some commodities as we approach the end of the year. The issue of Iran, whose production could increase by 1.7 mbpd (million barrels per day) if a nuclear agreement is reached, and a potential return to pre-pandemic oil production levels in the United States (about an additional 1.8 mbpd) are other downside risks to prices.

On top of these factors, the contribution of energy prices to US headline inflation is expected to decrease by 1 pp in the next six months due to base effects alone. In addition, assuming stable energy prices and oil prices of around 80 dollars/barrel, some analysts say that the impact of energy prices on core inflation could fall from 0.45 pp in the fourth quarter of 2021 to only 0.15 pp at end-2022.



–1PP:
the estimated impact of base effects on US inflation in the next six months

It will be important, however, to monitor the indirect effects of this rise in energy prices on household behaviour. The decline in purchasing power caused by these increases could actually lead to demands for wage increases and contribute positively to inflation.

Lastly, while this energy shock could last several more months before losing steam at the end of spring 2022, it raises questions about volatility shocks and the deeper problems the world could be facing at a time when most governments are accelerating their energy transition policies. Although primary energy demand is expected to increase by 50% by 2050, the responses to this situation could be repeated in the future and fuel higher inflation if investments to improve production capacity are not ramped up.

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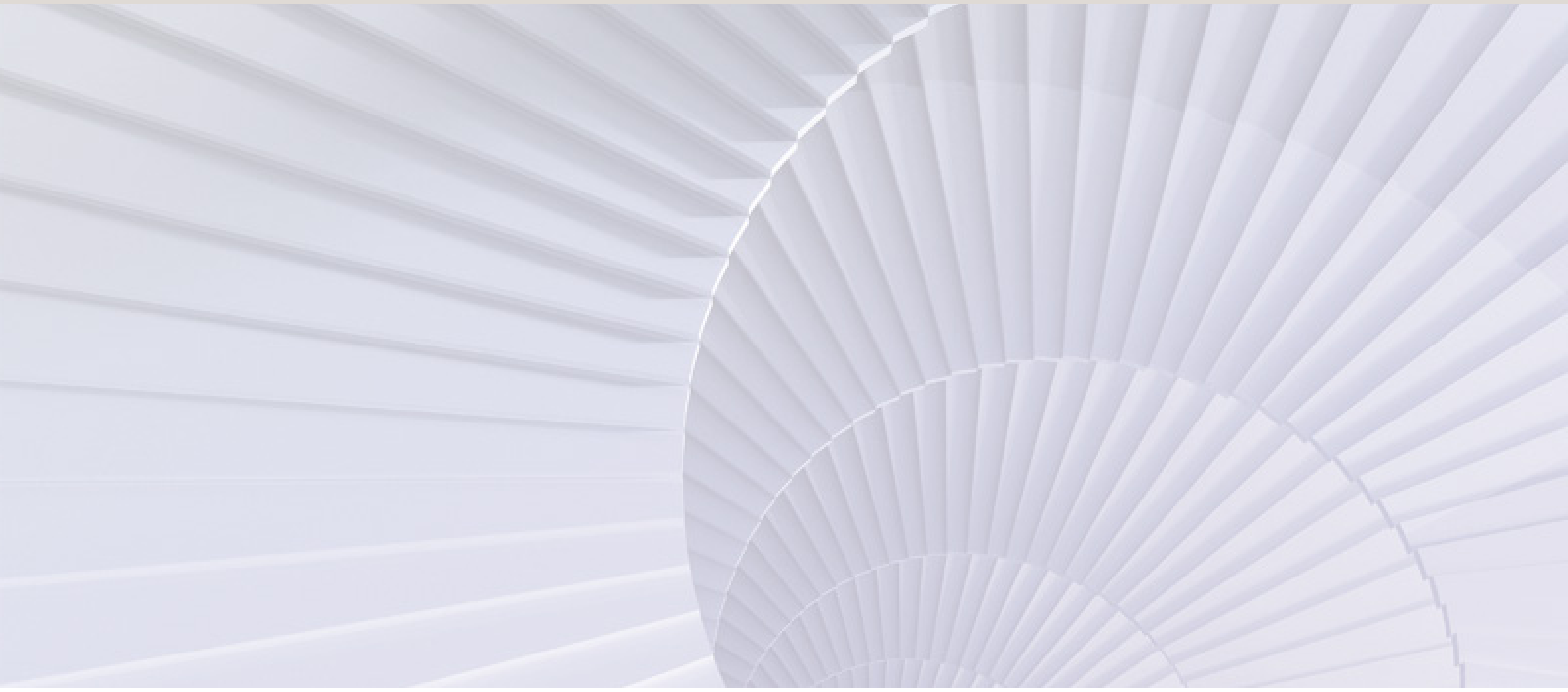
INFLATION AND SUPPLY CHAINS

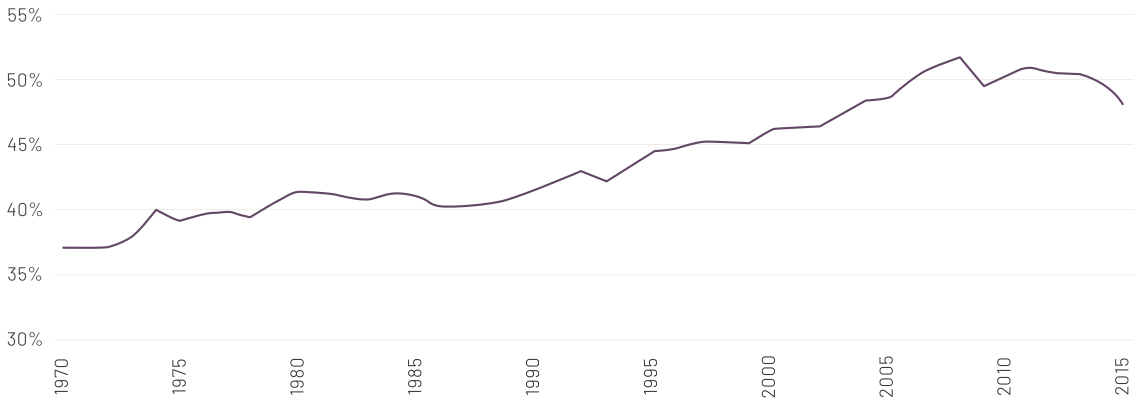


The supply chain issue is just one of many factors that led to higher inflation, but it is likely the one that was most difficult to anticipate and whose future trajectory remains unclear. The number of companies that mentioned supply constraints in the third quarter doubled from the previous quarter. However, several indicators suggest that this issue will persist to some extent for most of 2022.

After three decades of globalisation, the share of world trade affected by global value chains (GVCs) is between 45% and 50% (Chart 4). Given the high levels of interdependence and widespread adoption of low-inventory just-in-time management, a few jammed links can disrupt the entire chain (Chart 5).

That is what happened this year: there were no widespread shortages, just localised shortages of materials which, when combined with logistics constraints and labour shortages, caused a surge in delivery delays and forced production cuts.

CHART 4: WEIGHT OF GLOBAL VALUE CHAINS IN WORLD TRADE, %



Source: World Bank, Indosuez Wealth Management.

Semiconductor-related SHORTAGES seem likely to last longer than expected

What are the key issues that continue to cause problems for supply chains?

- The ongoing lockdown measures in Asia (zero-COVID policy in China, low vaccination rate in Vietnam), which are affecting both freight transport and the production of intermediate goods.
- Temporary energy shortages, which are leading to forced plant closures in China, and basic materials production shortfalls (wood, metals, paper), which have an impact on intermediate goods and finished products, as well as on sectors such as construction.
- Longer-lasting semiconductor-related shortages, which have a knock-on effect on many sectors (smartphones, computers, automotive, other connected objects).
- A labour shortage in port logistics and transport in the United States, which has led to longer delivery times. The most striking image in this respect is the port of Los Angeles, where dozens of container ships are still waiting to port due to the lack of dockers.

Which bottlenecks do we believe can be resolved quickly and which ones might last longer?

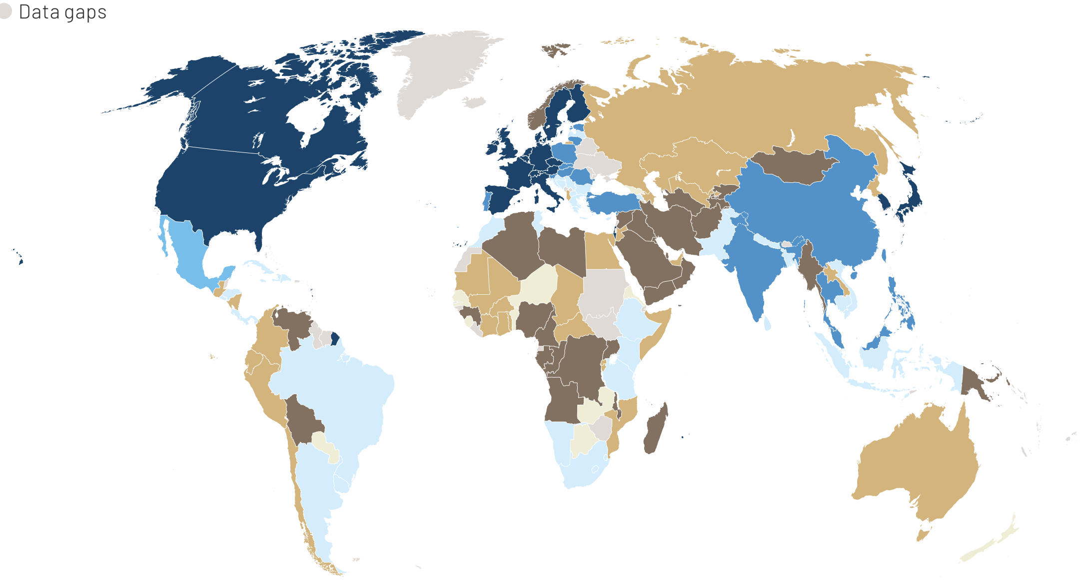
First, if we assume higher vaccination rates in Southeast Asian countries, and effective booster campaigns against potential variants, it could be argued that the port bottlenecks we saw in the summer of 2021 in China are not likely not recur; however, China is maintaining its zero-COVID policy and the COVID-19 epidemic is now gathering steam again in several countries.

Second, it is likely that the temporary energy and basic materials imbalances can be explained in part by different recovery speeds in 2021, and thus that the convergence of growth rates towards 3%-5% next year will reduce these deficits. Some commodity shortages, such as wood, already seem to have been resolved in the United States. Energy prices are expected to be rebalanced next year. The current slowdown in growth of the Chinese economy is already easing pressure on the prices of some commodities, such as metals.

CHART 5: ALL COUNTRIES PARTICIPATE IN GVCS, BUT NOT IN THE SAME WAY

GVC linkages, 2015

- Low participation
- Limited manufacturing
- Data gaps
- Limited commodities
- Advanced manufacturing and services
- High commodities
- Innovative activities



Note: The type of GVC linkages for a given country is based on: 1 - the extent of its GVC participation, 2- its sectoral specialisation in trade, and 3 - its engagement in innovation. Details are provided in figure 1.6 of the report.

Source: World Development Report 2020 team, based on the GVC taxonomy for 2015, Indosuez Wealth Management.

In contrast, there are no quick answers to the labour shortages; despite wage hikes for the least-skilled workers and the end of unemployment benefits for US households, the labour force participation rate is low and the imbalance between labour market supply and demand remains high in some sectors.

Lastly, semiconductor-related shortages seem likely to last longer than expected. Intel's CEO said in October 2021 that these shortages would likely not be resolved until 2023. This problem, initially attributed to a stronger-than-expected recovery, indicates less flexibility in the supply function and excessively low inventory levels at every stage of the chain.

X4

The cost to ship a container between China and Europe has

INCREASED FOURFOLD

With these ongoing tensions and higher logistics costs, one might assume that these volume imbalances would continue to affect the prices of both goods and services. The cost to ship a container between China and Europe has increased fourfold and the freight rate index (Chart 6) is, for now, showing no signs of consolidation; at this point, it is merely stabilising.

DHL, for example, announced a more than 5% rate hike for the coming year. It is still difficult to determine whether the major groups will start to overhaul their value chains and bring some of their production back in-house. This latter idea comes up against some real obstacles (the time and investment needed to revamp production equipment, lack of know-how). But we can nevertheless assume that companies will want to secure higher levels of inventories which should be reflected in their prices.

In conclusion, the supply chain challenges related to commodity shortages or freight bottlenecks should be addressed in the coming months and should stop contributing to inflationary pressures. These challenges are likely to persist beyond 2022 in certain manufacturing sectors, such as electronics and automotive. In the longer term, we can expect that supply security and major countries' quest for greater strategic autonomy in key industries could help reverse the deflationary pressures of the last few decades.

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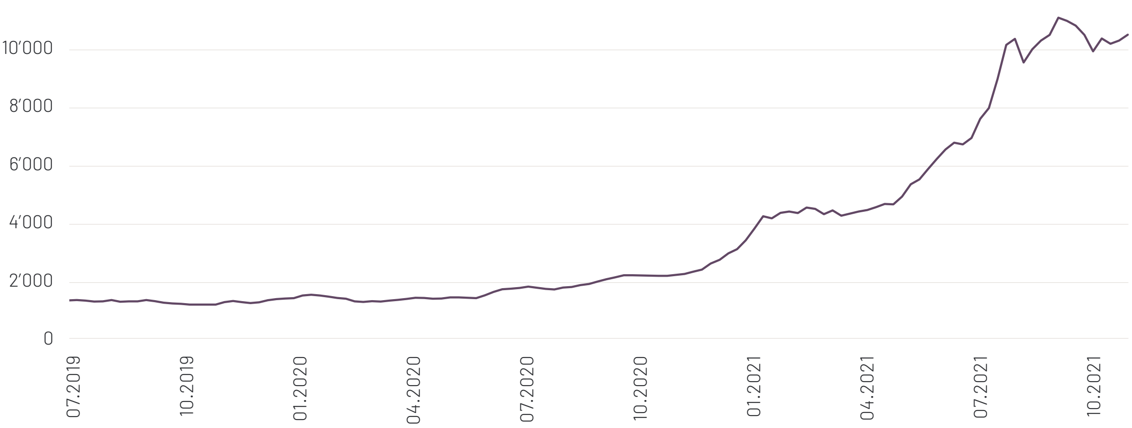
CHART 6: CONTAINER PRICE INDEX, JULY 2019 TO OCTOBER 2021, USD



Source: Bloomberg, Indosuez Wealth Management.

02 • *Focus on inflation drivers*

IS THERE A RISK OF WAGE INFLATION?

The pandemic – which curbed the globalisation that causes wage disinflation – and the subsequent sharp global economic recovery this year triggered a labour shortage that put pressure on wages.
Should we be concerned that the wage-inflation spiral of the 1970s will re-emerge, or rather that the scale and length of the rebalancing will be limited?

NEW
TECHNOLOGIES
should continue
to drive
PRICES DOWN

WAGE SITUATIONS VARY BY COUNTRY

Current concerns are focused on a repeat of the wage-price spiral that would affect corporate margins and then be passed on to prices. This relationship generally occurs when there is full employment.

While wages have recently trended up, the situation varies by country. In the United States, where employment has not been protected like it is in Europe, government cheques, school closures and the health situation made it difficult for workers to return, causing imbalances and wage pressures.

In Europe, the unemployment rate remains high. The exception is Germany, where wage pressures have grown persistent with a stronger recovery and the economy nearing full employment. England is in a different situation, as a number of foreign workers have left because of Brexit and the pandemic. These workers now need to obtain a residence permit if they are to return.

The normalisation of global growth, after the sharp rebound in 2021 and the easing of constraints on the labour supply, should rebalance employment and limit wage pressure to a few very specific sectors.

USA :
a 4.8%
year-on-year wage hike

MORE OF A CATCH-UP IN LOW WAGES THAN AN ACROSS-THE-BOARD INCREASE

Wage hikes are accelerating, but this does not paint a full picture. The pandemic led to a temporary labour shortage primarily in the sectors that were hardest hit by the lockdowns.

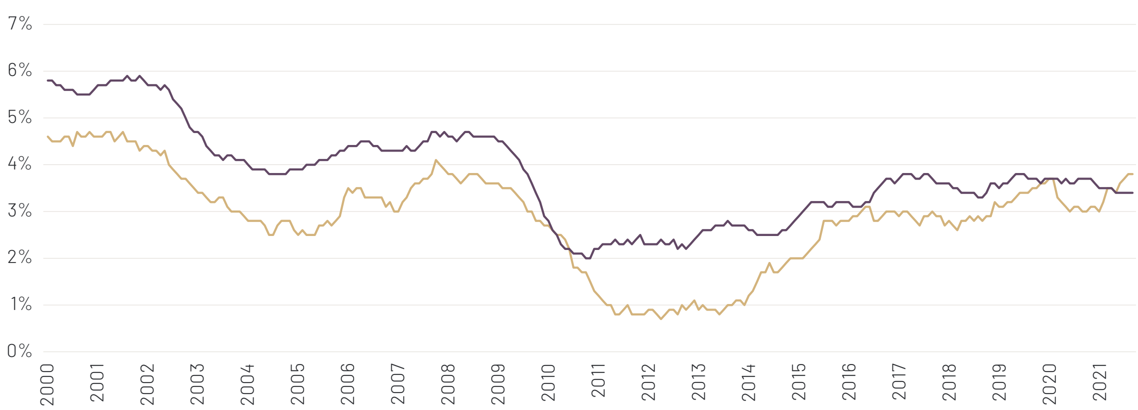
The wage hike in the United States reached 4.8% year-on-year, but with increases of more than 10% in sectors where vacancies exceed applications, such as leisure, hospitality and transportation, mainly low-wage jobs (Chart 7). This was the case in Europe as well.

Two factors are offsetting the impact of this sharp rise.

First, the growth in high wages is slowing. Second, productivity gains have led to a decline in unit labour costs. As long as productivity increases faster than wages, as has been the case since the 1980s, there is no reason to fear the wage-price spiral (Chart 8).

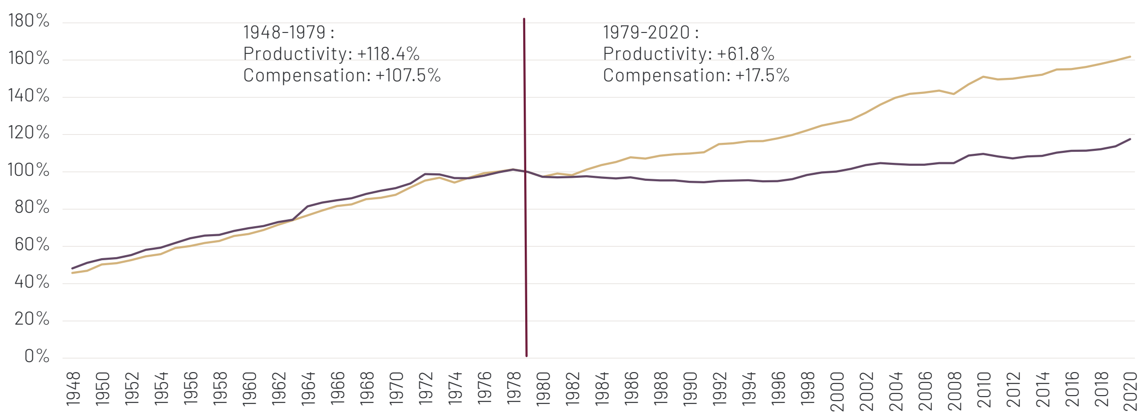
We are very likely seeing adjustments to low wages rather than runaway wage hikes. However, in response to the pandemic-heightened labour shortage, major US companies (Amazon, Walmart, etc.) are gradually moving towards the 15-dollar minimum wage backed by the Biden administration.

CHART 7: LOW WAGE ACCELERATION, %



Source: Bloomberg, Indosuez Wealth Management.

CHART 8: PRODUCTIVITY AND PAY IN THE UNITED STATES, %



Source: Economic Policy Institute, Indosuez Wealth Management.

STRUCTURAL FACTORS ARE CURBING WAGE PRESSURES

Certain structural factors are keeping a repeat of the wage-price spiral at bay.

First, wages are currently no longer indexed to inflation.

Second, even if some core business activities were to be relocated to developed countries, thereby lessening the deflationary power of globalisation, international competition will not go away which ensures wage pressures will be kept in check. Furthermore, ageing populations in many developed economies act as a deflationary factor, a trend that the Japanese case epitomizes all too well.

Lastly, automation and robotisation in the least-skilled activities, as seen in Germany and Japan, are driving productivity gains.

CONCLUSION

Wage acceleration is mostly cyclical and mainly affects a few well-identified sectors. Beyond the short-term impact, the wage-price spiral has not materialised and is not expected to affect corporate margins. The inflationary risk is more intimately tied to a persistent rise in energy or food prices, which would create more powerful social and wage pressures.

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US HOUSING - NO SHELTER FROM HIGH PRICES

Although house prices do not appear directly in the CPI (Consumer Price Index), they do influence the index indirectly and with a lag. The cost of shelter is a significant component of the CPI in the United States. Given the unparalleled recent growth in prices and rents, it is very likely that housing costs will continue to rise in the short term, especially if the imbalance between supply of and demand for housing persists.

Shelter makes up

32%

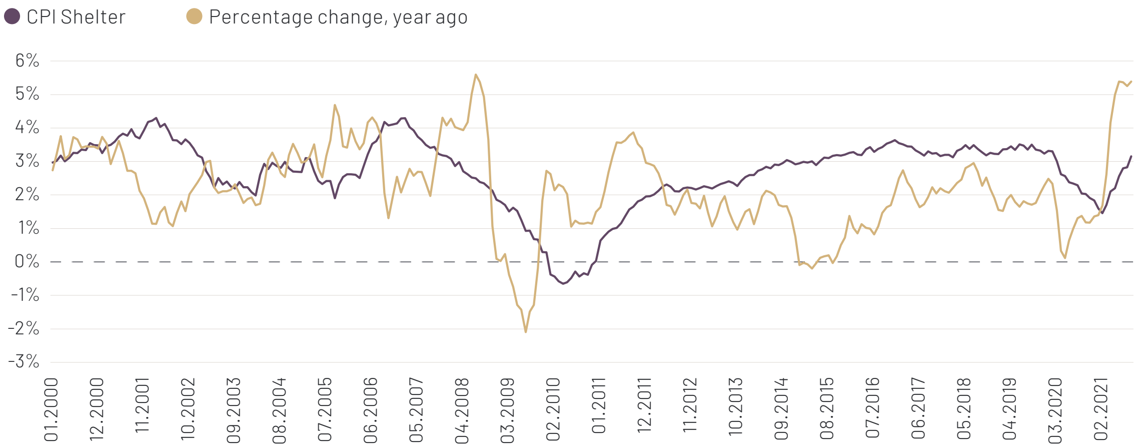
of the United States' CPI consumption basket

HOME PRICES INDIRECTLY INFLUENCE SHELTER INFLATION WITH A LAG

The CPI survey collects the rental costs of around 8'000 residential units each month to compute the indices for the housing component[1]. If the residential unit is owner-occupied, the Bureau of Labour Statistics (BLS) uses an estimate of the rental value of the property (owners' equivalent rent of primary residence or OER[2]). House prices are not used to calculate Shelter CPI (Chart 9), although they do indirectly influence shelter inflation with a reported lag of between 1-2 years.

Shelter currently makes up 32% of the United States' CPI consumption basket, with rents accounting for 8% of headline CPI, and OER accounting for 24%[3]. As a comparison, the euro area HICP (Harmonised Indices of Consumer Prices) does not include an owner's equivalent of rent, only rents. Given the fact that the euro area has a homeownership rate of between 60 and 70%, the HICP does not fully reflect the (rising) cost of housing in Europe[4].

CHART 9: CPI FOR ALL URBAN CONSUMERS: SHELTER IN US CITY AVERAGE, %



Source: US Bureau of Labour Statistics, Indosuez Wealth Management.

1 - US Bureau of Labour Statistics 2020, *Consumer Price Index : Data Sources*, https://www.bls.gov/opub/hom/cpi/data.htm.
2 - US Bureau of Labour Statistics 2009, *How the CPI measures price change of Owners' equivalent rent of primary residence (OER) and Rent of primary residence (Rent)*, https://www.bls.gov/cpi/factsheets/owners-equivalent-rent-and-rent.pdf.
3 - US Bureau of Labour Statistics 2021, *Consumer Price Index – September 2021*, https://www.bls.gov/news.release/pdf/cpi.pdf.
4 - CEPS 2021, *The rising cost of housing: the ECB continues to understate the true cost of living in its new Strategy*, https://www.ceps.eu/the-rising-cost-of-housing/.

HOME PRICES IN THE UNITED STATES HAVE RECENTLY POSTED THE STRONGEST GROWTH RATES SINCE RECORDS BEGAN

By july 2021, US home prices were posting annual growth rates of

20%

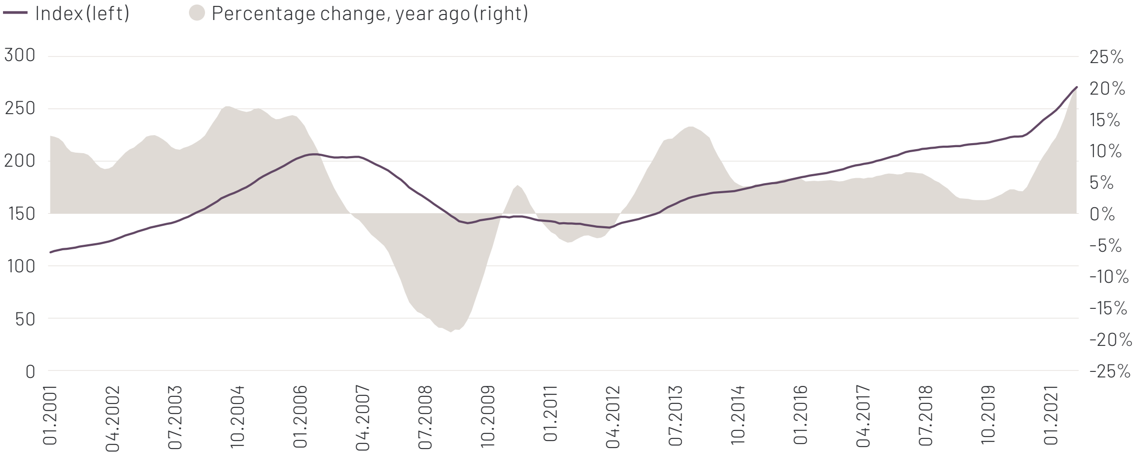
The pandemic depressed shelter inflation in the United States from spring 2020 to spring 2021. The index has since gained *momentum*, and by September, it was growing at an annual rate of 3.2%. In contrast, the sale price of single-family homes in the United States accelerated dramatically during the pandemic. By July 2021, the S&P CoreLogic Case-Shiller Index (Chart 10) was posting annual growth rates of 20%, the strongest in the series' history. Exhibiting a similar development, the FHFA (Federal Housing Finance Agency) House Price Index posted an annual growth rate of 18.5% in August 2021.

The increase in demand for owner-occupied homes during the pandemic was exceptional. The nationwide working-from-home experiment gave American employees the flexibility to live further away from their place of work, often outside expensive metropolitan areas[5].

Mortgage rates also reached record-low levels (2.65% for the 30-year Fixed-Rate Mortgage in January 2021[6]), encouraging more people to buy real estate for the first time, to upgrade to more expensive properties, or to buy second homes[7]. Furthermore, millennials have reached their peak homeownership years[8] and investors continue to be very active in the single-family home market[9].

In parallel, there is a well-documented housing shortage in the United States, exacerbated during the pandemic by work stoppages, supply-chain disruptions, and high input costs (including wages). Freddie Mac, the federally backed home mortgage company, estimates that the shortage currently stands at 3.8 million homes, up from an estimated 2.5 million in 2018. According to them, entry-level supply is particularly restricted: the share of entry-level homes in overall construction declined from 40% in the early 1980s to around 7% in 2019[10]. Although this demand-supply imbalance varies between markets, it is particularly pronounced in states that have experienced strong economic growth, attracting workers from other states[11].

CHART 10: S&P/CASE-SHILLER HOME PRICE INDEX - 20-CITY COMPOSITE (SA)



Source: S&P Dow Jones Indices LLC, Indosuez Wealth Management.

5 - Joint Center for Housing Studies 2021, *The pandemic reveals the need for space, but building smaller units remains essential*, https://www.jchs.harvard.edu/blog/pandemic-reveals-need-space-building-smaller-units-remains-essential.
6 - Freddie Mac.
7 - Bankrate 2020, *Experts forecast more low mortgage rates, millennial homeownership surge*, https://www.bankrate.com/mortgages/low-rates-continue-millennial-homeownership-corelogic/.
8 - CoreLogic 2021, *Millennials Lead the Pack for Home Purchases*, https://www.corelogic.com/intelligence/find-stories/millennials-lead-the-pack-for-home-purchases/.
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AFTER SLOWING DURING THE PANDEMIC, RENTS HAVE RAMPED UP DRAMATICALLY IN 2021

Although COVID-19 weighed down on rents in 2020, the national median rent increased by 16.4% during 2021, according to Apartment List. This is the fastest growth rate that the rental listings platform has seen on record[12]. This phenomenal rate of growth has since moderated somewhat, and 22 of the nation's 100 largest cities saw rents fall in October. Among these cities we find expensive coastal housing markets like San Francisco, which also witnessed its steepest rent declines throughout 2020, when tech workers saw remote working as an opportunity to move to less costly locations throughout the country.

President Biden's economic agenda includes plans to build more affordable housing[13], but homes take years to build, and the increased cost of labour and building materials are currently hampering construction[14]. Even if the singular demand surge that emerged during the pandemic dissipates, there is still a structural demand-supply imbalance, which will only intensify once Generation Z enters their home-buying years.

The average price of US homes will therefore continue to increase during the course of 2022, albeit at a reduced rate. Freddie Mac forecast home price growth to slow down to 7% in 2022 after posting 17% growth in 2021 as a whole.

The recent surge in US house prices and rents, together with the fact that in September 2021 the CPI Shelter was still below its pre-pandemic rates of growth, point to an increase in housing costs during the course of 2022. The average 30-Year Fixed Mortgage Rate has risen to over 3% since its early 2021 lows, and is currently forecast to rise modestly by the end of 2021, as the Treasury yield reacts to an uplift in short-term rates in order to control inflation. Although a meaningful increase in long-term rates will almost certainly dampen demand for mortgages and therefore owner-occupied housing, a more sustainable way to manage shelter cost pressures is to tackle the housing market's structural mismatch between supply and demand.

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12 - Apartment List 2021, *Apartment List National Rent Report October 2021*, https://www.apartmentlist.com/research/national-rent-data.
13 - The White House 2021, Fact Sheet: *Biden-Harris Administration Announces Immediate Steps to Increase Affordable Housing Supply*, https://www.whitehouse.gov/briefing-room/statements-releases/2021/09/01/fact-sheet-biden-harris-administration-announces-immediate-steps-to-increase-affordable-housing-supply/.
14 - NAHB 2021, *Building Materials Prices Climbing at Record Year-to-Date Pace*, https://nahbnow.com/2021/08/building-material-prices-climbing-at-record-year-to-date-pace/#:~:text=Despite%20significant%20drops%20in%20framing,the%20Bureau%20of%20Labor%20Statistics.

02 • Focus on inflation drivers

ARE THE LONG-TERM FACTORS STILL DEFLATIONARY?

Beyond short-term supply chain issues and rising energy prices, we are revisiting the impact certain long-term factors can have on inflation. These include trade globalisation, the ageing of the population, the social model, new technologies, and the energy transition.

Inflationary fears resurfaced in 2021, driven mainly by a number of short-term factors such as the lack of semiconductors, rising energy prices and global supply issues. While these factors may temporarily affect prices of goods and services, they will not necessarily have a lasting impact on inflation. At its core, inflation is a general and lasting increase in the prices of goods and services.

Long-term (i.e. secular) factors are therefore key when analysing inflation, even though they can sometimes (or often) come into play beyond the time frame used in the central banks' analysis[15]. How, for example, can we explain the very low inflation in the United States between 2015 and 2020, at a time when the unemployment rate was trending down and should therefore have automatically increased demand for goods and services and thus caused inflation? Even in 2019 when the unemployment rate reached 3.5%, its lowest level of the last 50 years, inflation remained contained at around 2% in the United States. Nevertheless, a recent analysis by the San Francisco Fed[16] showed that structural inflation remained very low in the last decade but increased sharply in 2021.

What are these long-term forces that kept inflation in check, and can we expect any structural changes to come about?

15 - See, for example, the work of the San Francisco Federal Reserve on cyclical and structural effects on inflation: https://www.frbsf.org/economic-research/indicators-data/cyclical-and-acyclical-core-pce-inflation/.
16 - See *What's Behind the Recent Rise in Core Inflation?*, SF Fed Blog, 18 June 2021.

The return to the workforce of the

55 AND OLDER

group may be deflationary

A JOB MARKET WITH A LOT OF UNTAPPED POTENTIAL

While the ageing of the population should, in principle, automatically reduce the labour supply, the exact opposite has happened because the labour force participation rate of baby boomers (those born between t and 1968) has continued to rise. In the United States, the participation rate of those aged 50 and older rose from 30% in the 1990s to nearly 40% pre-COVID-19 (Chart 11). The entry of more women into the job market is another long-term factor that supports the labour supply. While the participation rate of women rose from 52% in the 1980s to 60% in the early 2000s in the United States, it has fallen steadily in the last 20 years and remains 10-15 points below the participation rate of men.

Moreover, the overall participation rate has fallen, mainly due to the uberisation of the economy, the creation of jobs without employee status and often subject to difficult working conditions. This much-touted and newly developed gig economy also represents a pool of potential employees who could return to the more traditional labour market.

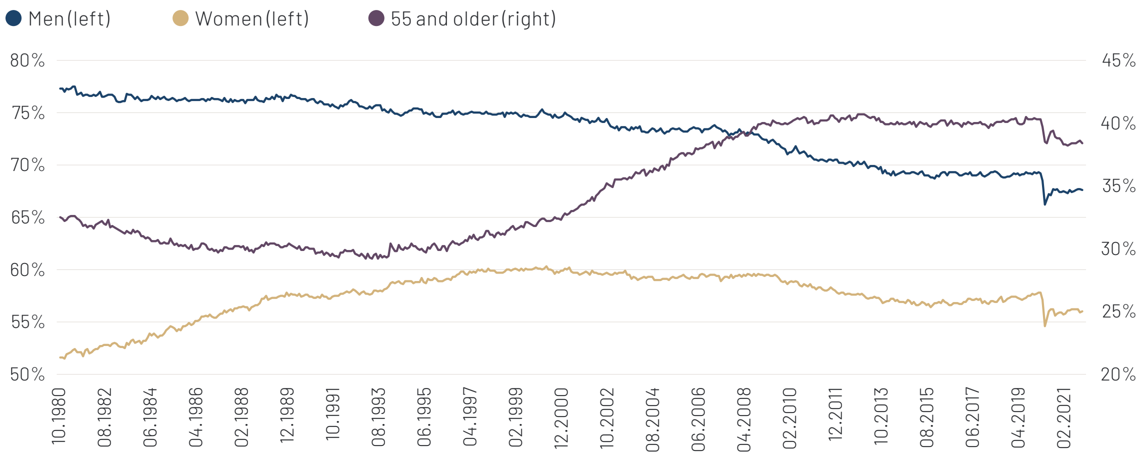
While the baby boomer effect could wane, women's access to the labour market and the insecurity associated with certain jobs due to the rise of non-employee contracts could continue to create a large pool of potential employees, which could reduce wage pressures and the resulting inflation.

TRADE GLOBALISATION AND DEFLATIONARY PRESSURES

The other major deflationary force in the last 30 years has been trade globalisation. The tariffs charged among major trading partners have fallen since the end of the 1980s. This was the result of the Uruguay cycle, the largest negotiation held under the auspices of the World Trade Organization (WTO). It brought together more than 120 countries and covered almost all trade.

One consequence of the Uruguay round was that it allowed developing countries to increase their manufacturing production and developed countries to offshore their production facilities and make low-cost purchases abroad. The expansion of the European Union (EU) to Eastern European countries also strengthened this dynamic among European countries, enabling French, German and Northern European countries to offshore to Poland or the Czech Republic, for example.

CHART 11: PARTICIPATION RATES ON THE US JOB MARKET, %



Source: Bloomberg, Indosuez Wealth Management.

THE DEFLATIONARY **EFFECT** of globalisation has possibly reached its limits

While trade globalisation has had a deflationary effect over the last 30 years, its negative impact on prices has possibly reached its limits. First, the wage convergence resulting from global growth has benefited developing countries. China, which has been the world's factory for 30 years, could lose its competitiveness and some of its production capacity to Southeast Asia. Trade tariffs are also very low by historical standards, as seen in Chart 12. We could therefore expect this factor to reverse if protectionism grows.

DISTRIBUTION OF VALUE-ADDED

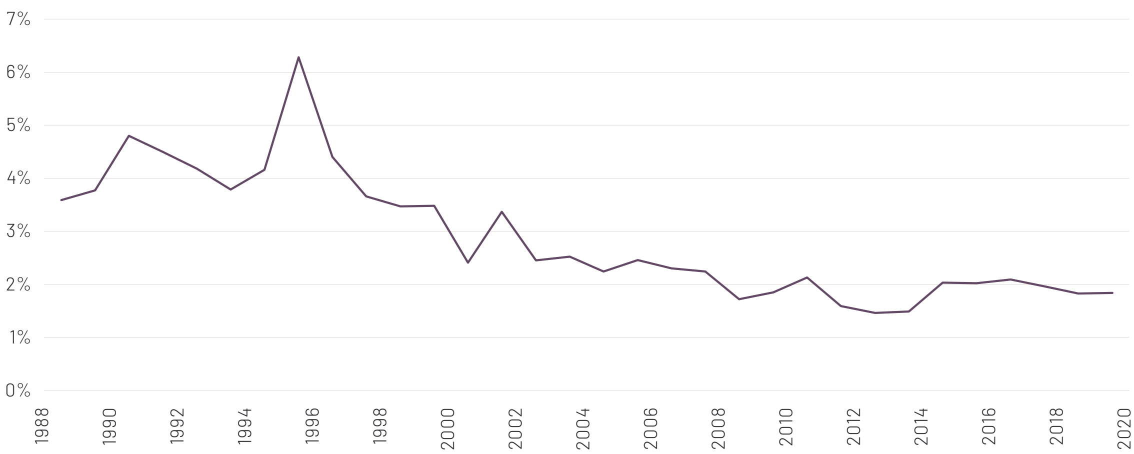
In the second half of the 20th century, there was a fairly strong connection between the distribution of value-added and inflation: in an inflation-tolerant regime, Keynesian regulation and the collective bargaining model of the 1950s to 1970s produced wage-price spirals that led to the distribution of value-added to employees.

Conversely, the liberal revolution of the 1980s and 1990s, characterised by the three prongs of monetarism, deregulation, and globalisation, led to a less favourable distribution of value-added to employees. This resulted from a reassessment of both wage indexation (disinflation policies) and the collective bargaining framework, and from international competition, which put pressure on wages in industry due to offshoring. The diagnosis has become less clear-cut since 2000 as technical progress, digitalisation and the strong concentration of the technology sectors led to productivity gains and gave large companies pricing power. This helped increase the weight of profits in value-added. In a more leveraged world, trade that is more highly regulated and less globalised could give rise to a regime with a social and political preference, striking a balance with slightly higher inflation but without returning to the inflationary spiral of the 1970s.

INNOVATION AND PRODUCTIVITY

The price of services has declined, due in part to a steady flow of technology from the digitalisation of certain services, the sharp growth in the cloud, and improved semiconductor performance. This trend does not appear to be waning, as the United States is now facing very stiff technological competition, chiefly from China. Many industries are undergoing rapid transformations, including the financial sector which is marching steadily towards digitalisation. The solutions of the future, such as quantum computing, could also vastly increase calculation capacities and thus pave the way for numerous innovations in sectors such as semiconductors, cybersecurity and the metaverse[17], which was popularised in 2021. Innovation and the development of new technologies should therefore continue to have a moderating effect on inflation overall.

CHART 12: AVERAGE EU TAX RATE, ALL PRODUCTS, %



Source: WTO, Indosuez Wealth Management.

17 - Portmanteau of meta and universe (see glossary).

CO_2

Is the
150’000
BILLION
DOLLARS
needed to reach carbon neutrality an inflationary factor?

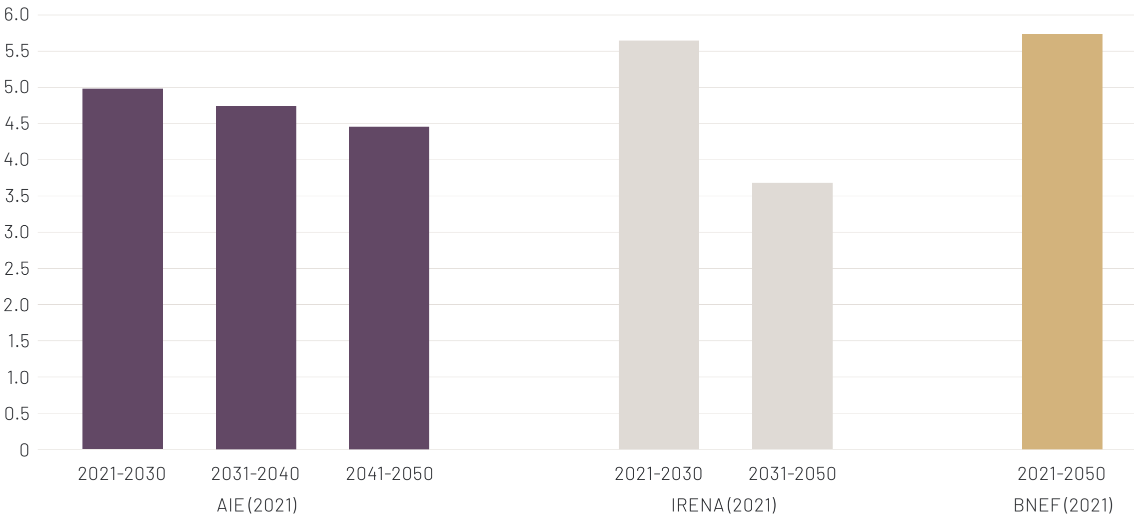
THE GREAT UNKNOWN OF THE NEXT 30 YEARS: THE ENERGY TRANSITION

The publication of the IPCC’s report and COP26 in Glasgow serve as a reminder of the current climate emergency. What impact will the changing climate have on inflation? If no steps are taken, a recent study by Mukherjee and Ouattara (2021)[18] aims to show a strong connection between climate change and inflation, as rising temperatures and greenhouse gas emissions can have a significant impact on the price of agricultural products and healthcare costs.

If we act jointly to meet the “net zero” CO_2 emissions target, we might need up to 5’000 billion dollars per year for the next 30 years to meet targets, amounting to a total of 150’000 billion dollars or two times global GDP (Chart 13).

The energy transition’s impact on changes in the price of goods and services is still largely unknown because it will depend on two factors: the steps taken by governments to finance it and companies’ ability to adapt. On the one hand, it will not be possible to limit global warming to 1.5°C, as agreed to by G20 members in 2021, without restrictive mechanisms based on the polluter-pays principle, such as a broader carbon tax. On the other hand, the energy transition represents a tremendous investment opportunity and thus an additional source of economic growth. COP26, for example, highlighted electric vehicles as one way to reduce greenhouse gas emissions. While they had only a marginal presence just 10 years ago, electric vehicles now represent nearly 5% of new vehicles sold and could be in the majority by 2035. This success can be attributed to a combination of tax incentives and technological breakthroughs that significantly reduced the cost of batteries while increasing their capacity.

CHART 13: INVESTMENT NEEDED TO REACH NET ZERO CO_2 EMISSIONS BY 2050, TRILLIONS OF DOLLARS



Source: Bruegel based on IEA (2021), IRENA (2021), BNEF (2021).

18 - See Mukherjee, K., Ouattara, B. (2021). Climate and monetary policy: do temperature shocks lead to inflationary pressures? Climatic Change 167, 32.

The shift to electric vehicles will, however, sharply increase the need for "green" electricity. However, 2021 served as a reminder that renewable energy production is subject to weather conditions. Whether this means wind in the North Sea or dam levels in the United States, the consequence is that energy prices could remain both high and volatile. This could result in marginally higher prices as well as a more significant increase in the inflation risk premium, which could adversely affect growth as heightened uncertainty might prompt companies to reduce their investments.

Ultimately, the significant investments generated by the energy transition will have to translate into either lower profitability or higher energy prices which could, at the very least, lead to a reallocation of market baskets.

After about 20 years of very low inflation due to a combination of deflationary factors, inflation could, in the long term, return close to or above the central banks' inflation targets. The central banks will have to make sure that inflation remains both contained and predictable to provide companies with a stable economic environment.

NICOLAS MOUGEOT
Head of Global Trends and ESG Advisory,
Indosuez Wealth Management

03 | Our view: Implications for our 2022 scenario

03 • *Our view: Implications for our 2022 scenario*

INFLATION AND GROWTH TRAJECTORIES FOR 2022-2023

The macroeconomic recovery was robust in 2021, driven by massive *stimulus* plans and an acceleration in vaccinations. Developed countries were thus able to reopen their economies. However, the pace of growth now appears to be slowing, with supply constraints dampening economic activity and providing warning signs of future inflation levels. So what should we expect in the coming quarters?

DEVELOPED COUNTRIES: TRANSITIONING TO A NORMALISED PACE OF GROWTH

The latest business survey trends in both the United States and Europe indicate that the recovery has peaked in developed countries. Despite the slowdown, growth is still projected to be strong in 2022. The effects of the extraordinary support measures implemented earlier this year, which helped activity in the United States return to pre-pandemic levels in the second quarter of 2021, are now being watered down, yet growth is still expected to remain high.

However, the risk typology has changed: we have shifted from a demand-constrained economy, due to the health restrictions, to a supply-constrained economy, in which the boomerang effect on demand has led to supply chain congestion and reduced production capacity.

We therefore estimate that growth could reach +3.3% in 2022 in the USA, before falling back to just above 2% in 2023.

CONSUMPTION is expected to remain a powerful GROWTH DRIVER

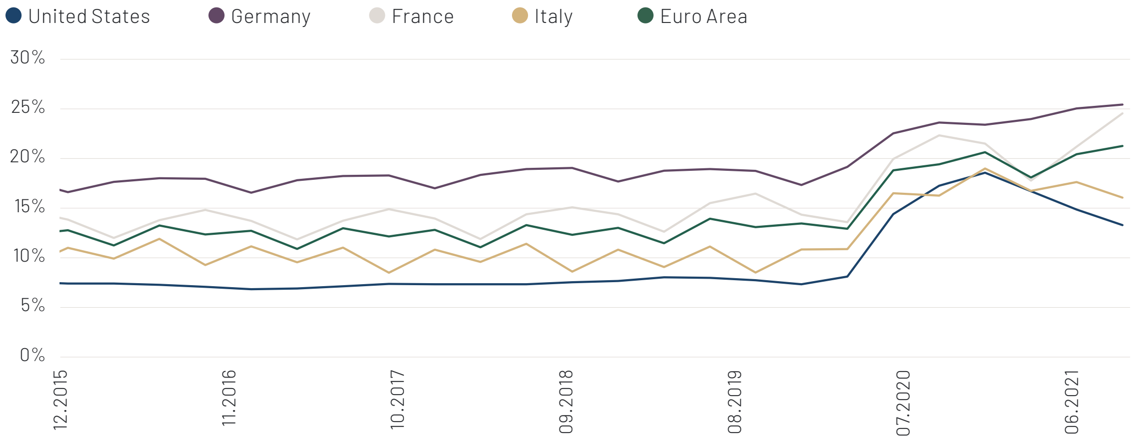
First, consumption should remain a powerful growth driver in the coming quarters (Chart 14) due to a combination of household dissaving (mainly in Europe) and fiscal policy support. But only if supply constraints ease and there are no major resurgences of the COVID-19 epidemic that could affect demand.

Second, the negative impact of net exports could fade, while the easing of supply chain tensions could facilitate restocking and contribute positively to US growth later in 2022. These issues cost the US nearly two points of growth on an annualised basis in early 2021 due to massive destocking, longer delivery times, and an outright decline in sales (mainly in the automotive sector).

Conversely, public spending is expected to make a weaker but noticeable contribution next year (+0.1 to +0.2 pp of growth in the United States, +0.6 pp in the Euro Area), while the impact of new infrastructure plans will be more moderate and more spread out than previous COVID-19-related *stimulus* plans.

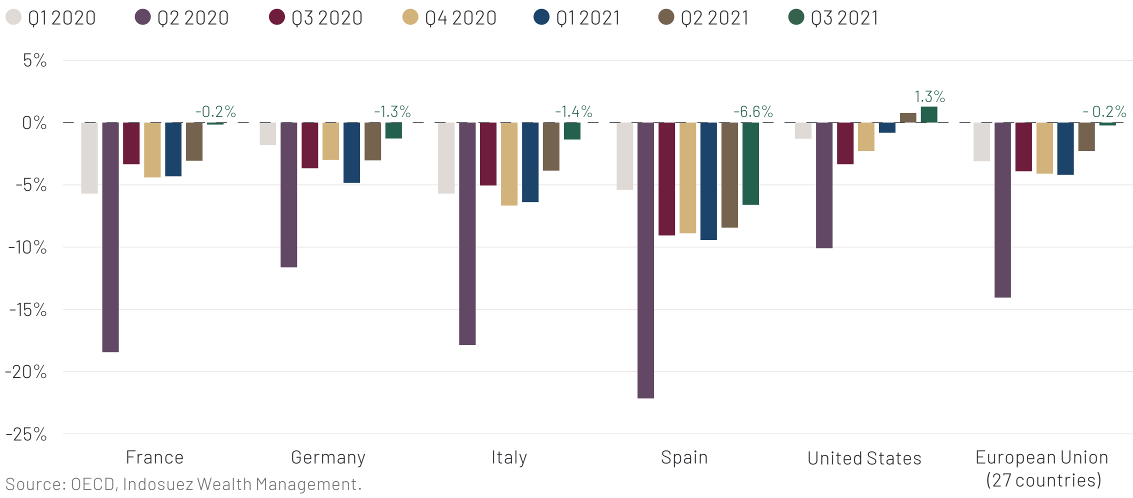
The Euro Area picture is similar overall, with its economies dragged down by supply constraints, although a country breakdown reflects more disparate recoveries. A contrast can be drawn between France, where activity has returned to its pre-crisis levels, and Germany and Italy, whose more industrialised economies have been harder hit (Chart 15).

CHART 14: PRIVATE CONSUMPTION SHOULD BE SUPPORTED BY HOUSEHOLD DISSAVING, %



Source: Bloomberg, Indosuez Wealth Management.

CHART 15: GDP, DIVERGENCE FROM PRE-CRISIS LEVELS, %



Source: OECD, Indosuez Wealth Management.

Are SUPPLY CONSTRAINTS the main risk to growth in 2022?

Nevertheless, while the pace of growth will also slow in the Euro Area, it should remain well above both the average pace reported in the decade before the crisis and potential growth: +3.9% in 2022 and +2.2% expected in 2023. This will be supported by the rebound in private consumption, still healthy order books, and *stimulus* funds, which will continue to drive productive investment (Table 1).

WILL INFLATION PLATEAU AT A HIGH LEVEL BEFORE FALLING BACK?

Inflation is expected to remain high in the first half of 2022, near its current levels in the United States, with a broader distribution across the different sectors of the economy: services, transport, and real estate. We will, however, monitor any de-anchoring of inflation expectations which could fuel more sustainable wage inflation, although this is not currently our core scenario. In Europe, the trend will be dictated mostly by the resolution to the energy price shock. Beyond short-term volatility and with the ebbing of supply chain tensions, inflation should come back down after spring 2022 and gradually move closer to the central banks' targets in 2023. It is forecast at 4.5%-5% in the United States and 2.5%-3% in Europe in the coming months.

EMERGING COUNTRIES: QUESTIONS ABOUT CHINESE GROWTH AND GEOGRAPHIC DISPARITIES

Moving eastward, the question of China's transition to a more sustainable growth model is once again front and centre. The Chinese economy, which was one of the drivers of global growth in early 2021, is expected to continue to face several short-term challenges: a zero-COVID policy, which continues to affect domestic demand; the forced and methodical deleveraging in the real estate sector, which will be a drag on investment and the economy as a whole (the total negative impact could depress the level of production by about 1.5% of GDP in 2022); environmental constraints, which will affect production levels; and a normalisation of western economies, which could potentially slow the pace of exports over time. Nevertheless, we believe the authorities will respond to these growth concerns by seeking to ease their policy through targeted economic support. This should keep the world's second-largest economic power from suffering an excessively sharp slowdown in GDP, which is estimated to grow by 4.9% in 2022.

TABLE 1: GROWTH AND INFLATION FORECASTS, %

	Growth in real GDP, % YoY					Inflation, CPI, % YoY				
	2019	2020	2021	2022	2023	2019	2020	2021	2022	2023
DEVELOPED COUNTRIES	**1.6%**	**-5.1%**	**5.0%**	**3.5%**	**2.0%**	**1.5%**	**0.8%**	**2.9%**	**2.8%**	**2.1%**
United States	2.2%	-3.4%	5.7%	3.3%	2.1%	1.8%	1.3%	4.4%	3.7%	2.8%
Japan	0.7%	-4.9%	2.4%	2.6%	0.9%	0.7%	0.3%	-0.4%	0.6%	0.6%
Euro Area	1.3%	-6.5%	4.9%	3.9%	2.2%	1.2%	0.3%	2.4%	2.4%	1.7%
Germany	0.6%	-4.9%	2.5%	3.9%	2.0%	1.5%	0.4%	3.1%	2.4%	1.7%
France	1.5%	-8.0%	6.1%	3.9%	1.8%	1.3%	0.5%	2.0%	2.3%	2.0%
Italy	0.3%	-8.9%	6.1%	4.8%	1.9%	0.7%	-0.1%	1.8%	2.3%	1.7%
Spain	2.0%	-10.8%	5.2%	5.9%	2.8%	0.7%	-0.3%	2.6%	2.4%	1.7%
United Kingdom	1.5%	-9.8%	6.9%	4.6%	2.4%	1.8%	0.9%	2.4%	3.7%	2.5%
EMERGING COUNTRIES	**3.8%**	**-2.0%**	**6.4%**	**4.3%**	**4.3%**	**4.3%**	**3.9%**	**4.2%**	**4.7%**	**4.1%**
Brazil	1.1%	-4.1%	5.1%	0.7%	1.5%	3.7%	3.2%	8.2%	7.5%	5.3%
Mexico	-0.3%	-8.3%	6.0%	2.7%	2.0%	3.6%	3.4%	5.6%	4.8%	3.8%
Russia	1.3%	-3.1%	4.2%	2.6%	2.5%	4.5%	3.4%	6.5%	5.6%	4.2%
India	4.2%	-7.1%	8.2%	6.3%	6.4%	3.7%	6.6%	5.0%	5.9%	5.6%
Indonesia	5.0%	-2.0%	3.5%	4.7%	5.1%	2.8%	2.0%	1.6%	2.9%	2.8%
China	6.1%	2.3%	7.7%	4.7%	4.8%	2.9%	2.5%	0.8%	2.1%	1.8%
South Africa	0.2%	-6.9%	4.6%	2.7%	2.3%	4.1%	3.2%	4.5%	4.8%	4.8%
Turkey	0.9%	1.6%	7.8%	4.4%	4.0%	15.5%	12.3%	17.7%	14.9%	11.3%
WORLD	**2.9%**	**-3.3%**	**5.8%**	**3.9%**	**3.4%**	**3.1%**	**2.6%**	**3.7%**	**3.9%**	**3.3%**

Source: Amundi Research, Indosuez Wealth Management.

The economic recovery process will be patchy in the rest of the emerging world due to sharp disparities in vaccination rates, but this temporal shift in the recovery should generally be positive for these areas, particularly in Southeast Asia where the gap is the greatest. Selectivity therefore remains key in terms of our geographic allocations in emerging countries. For example, the rise in inflation, particularly in Latin America, is forcing some central banks to normalise their monetary policy more quickly than expected, like in Brazil, and raises questions about the sustainability of public finances and the risk of fiscal policy slippage ahead of the scheduled elections.

In conclusion, we expect growth to remain robust in 2022 and exceed the levels of potential growth in developed countries. However, we believe the pace of growth will slow versus 2021. At the same time, several risk factors will need to be monitored and could prompt us to adjust our growth scenario next year: supply constraints should gradually ease but will continue to dampen production for much of 2022. At the same time, rising energy prices and the slowdown in China represent additional threats to private consumption and world trade. Lastly, monetary policy normalisation, particularly in the United States but also in certain emerging countries, could translate to more moderate growth in 2023.

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03 • Our view: Implications for our 2022 scenario

NORMALISATION TIME FOR THE CENTRAL BANKS. WILL THEY MOVE SLOWLY OR FAST?

Central banks have always played a large role in financial market equilibrium through monetary policy adjustments (key rate hikes and cuts). Their objective is to support growth when the economy slows or to keep the economy from overheating to avoid the risk of inflationary pressure.

To respond to the various successive crises since 2008, the impact of the central banks has been magnified with the introduction of new "unconventional" policy tools, asset purchase programmes ("quantitative easing") and, in some cases, a move to negative interest rates. Over the last decade, central bankers have sought to reawaken inflation expectations; there was even talk of "deflation" risk. They now find themselves in the opposite position, with inflation rising as growth slows.

A PARADIGM SHIFT TO COPE WITH INFLATION

But the winds of ultra-accommodative monetary policy appear to be shifting for the world's central banks. After a period of economic support, the time has now come for monetary policy normalisation. That raises the question of the speed of the tightening, which would ideally be gradual to ensure financial market stability. The scenario of a forced acceleration of this pace should also be considered to counter what may not be just a "transitory" rise in inflation.

CENTRAL BANKS appear to be moving away from their ultra-accommodative MONETARY POLICIES

Inflation developments remain one of the key factors in the central banks' analysis. In fact, their mandate includes an inflation control objective. The recent spike in prices worldwide is therefore currently the main topic of discussion among central bankers. They are facing a dilemma between a temporary rise in inflation and a slowdown in growth towards its potential in 2022. They need to do whatever it takes to keep inflation at a reasonable level without dampening economic growth. It was to best manage this dilemma that the central banks changed their inflation targeting strategy between 2020 and 2021 and increased their tolerance for inflation to run above the short-term target: "transitory" inflation!

Fed: The first KEY RATE hike is expected in the fall of 2022 in the US

THE NEED TO REGAIN FLEXIBILITY

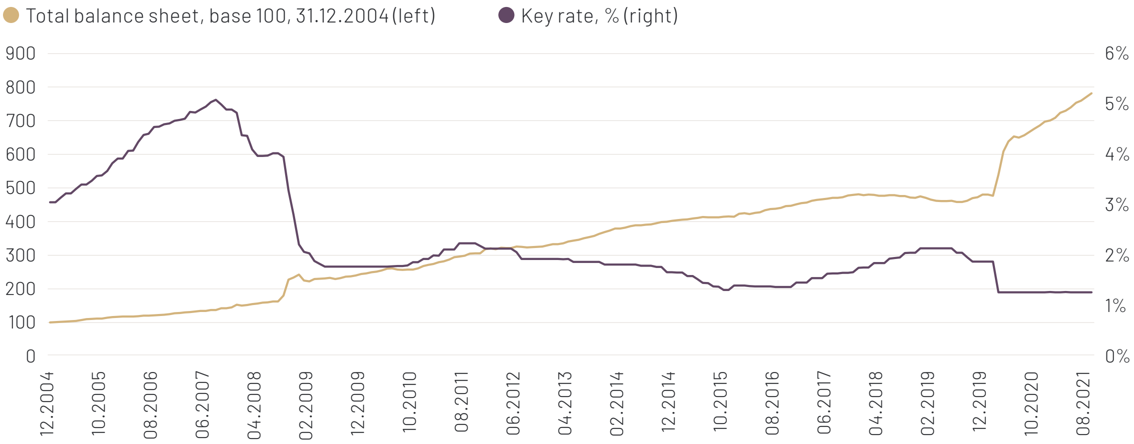
The central banks are also facing the need to regain flexibility with their monetary policy tools, as they are burdened with significant constraints: key rates are very low (if not negative) and balance sheets have expanded significantly (due to asset purchase programmes), as shown in Chart 16. This means that, in the event of an economic slowdown that requires *stimulus*, introducing more accommodative monetary policies would have little impact and provide limited room for manoeuvre in the absence of normalisation. Furthermore, if the reason for the slackening growth trend at the end of 2021 is supply constraints, an accommodative monetary policy is not the right tool to address the issue.

A RANGE OF NORMALISATION SPEEDS

Monetary policy normalisation is thus expected and necessary in the coming quarters, but the speed of these adjustments and their methods will vary greatly from one central bank to the next. Some have already begun to raise their key rates, mainly in response to inflationary pressures. These include Norway, New Zealand, South Korea, Mexico, and Brazil. Others, like China, retained sufficient flexibility by refraining from lowering their rates during the 2020 crisis, and are therefore in a position to keep them at those levels. It is thus important to have some insight into the expected actions of the major central banks in the coming quarters:

- Fed: the asset purchase programme (US Treasuries and mortgage-backed securities) will gradually be tapered during the first half of the year to sterilise the increase in its balance sheet. The first key rate hike is expected in the fall of 2022 in the US;
- European Central Bank (ECB): asset purchase tapering with the programme implemented during the pandemic (PEPP[19]) set to end in March 2022, but with other programmes expected to contribute to a continued increase in the ECB's balance sheet. Key rates are not expected to change before 2024 and should thus remain negative for an extended period.

CHART 16: AVERAGE CHANGES IN THE BALANCE SHEET AND KEY RATES OF THE MAJOR CENTRAL BANKS, %



Source : Bloomberg, Indosuez Wealth Management.

19 - Pandemic emergency purchase programme.

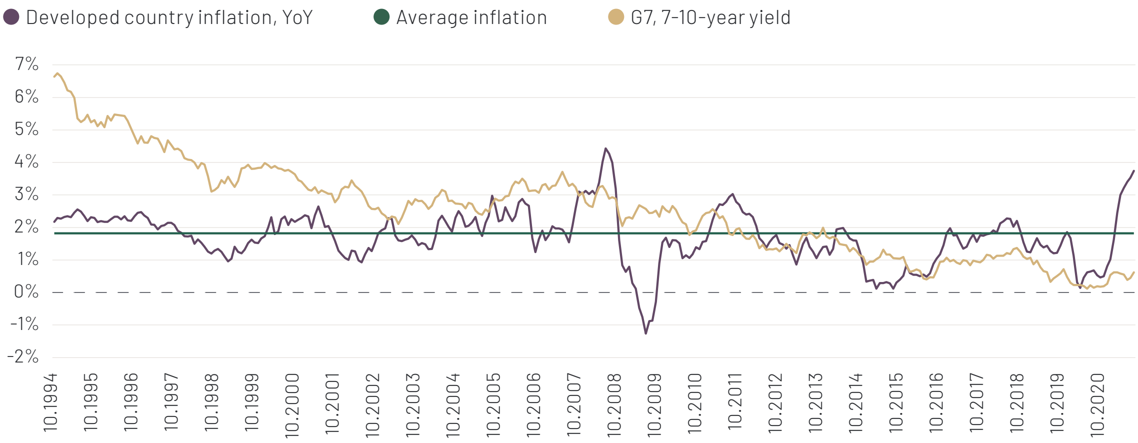
IMPACT ON LONG-TERM RATES

The asset purchase tapering is expected to have a modest impact on long-term rates insofar as the markets have been well prepared; we can therefore assume that this is factored into current long-term rates. The impact of higher US short-term rates on long-term rates is not automatic, and will depend in large part on the anchoring of inflation expectations. The current negative real rate situation, in particular in developed countries, is thus likely to continue in the coming quarters (Chart 17).

In their response to what they deem to be temporary inflation, which continues to surprise to the upside, the central banks have opted for patience and composure for now. But the members of the FOMC have in fact moved the first rate hikes up to end-2022, to counter falling unemployment and above-target inflation. A good balance between transparency and pragmatism is likely crucial to maintaining the confidence of the markets, which are no doubt just as concerned about an unexpected change in monetary policy as out-of-control inflation and long-term rates.

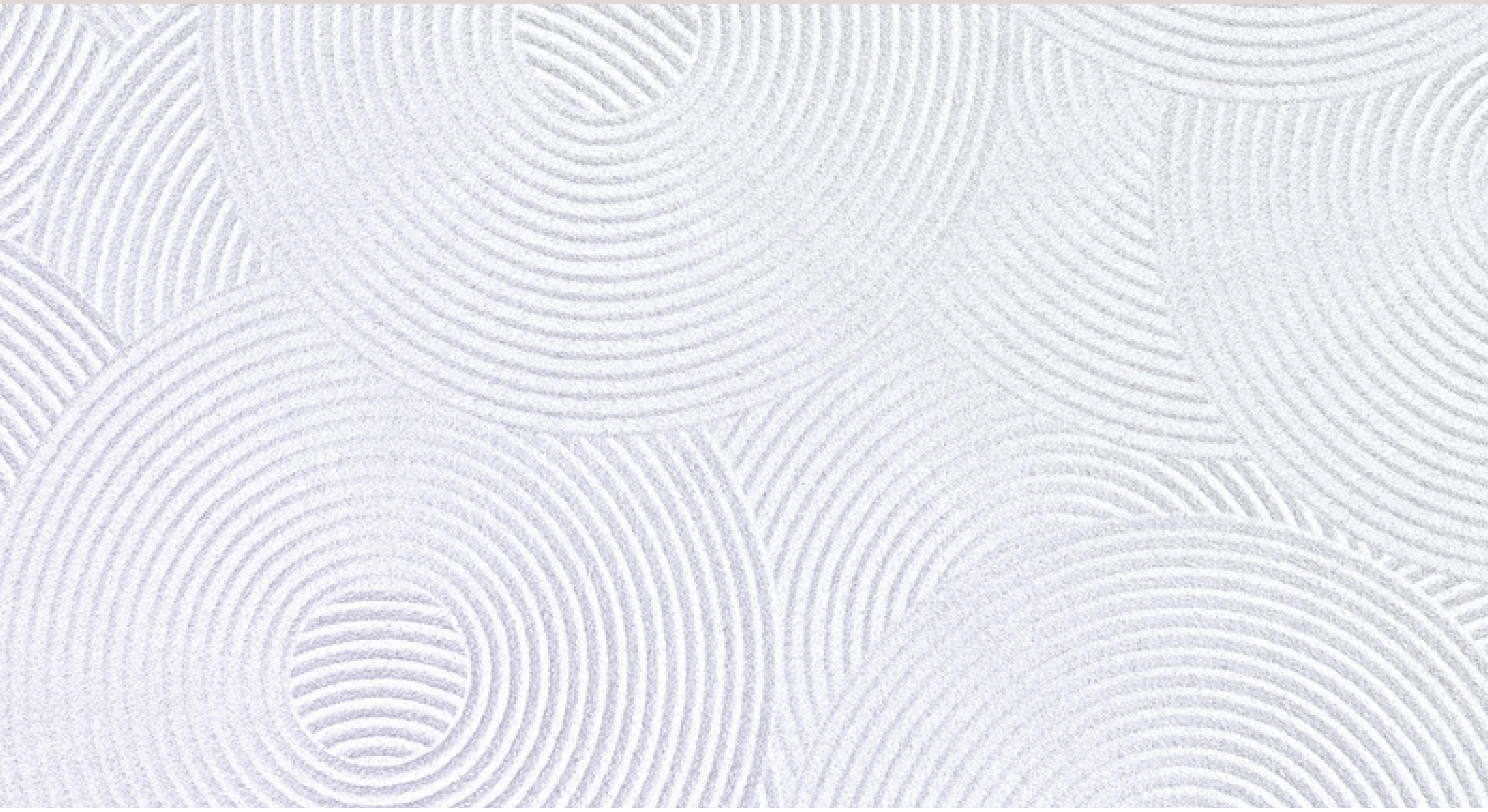
SÉBASTIEN FILLAUT
Global Head of Fixed Income,
CFM Indosuez Gestion

CHART 17: COMPARATIVE CHANGE IN AVERAGE INFLATION IN DEVELOPED COUNTRIES AND THE AVERAGE 7-10-YEAR YIELD, %



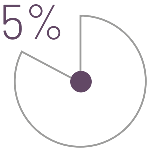
Source: Bloomberg, Indosuez Wealth Management.

WHAT IS PRICING POWER?



Pricing power is a company's ability to set prices. Investors seek this out as a differentiating factor. Pricing leverage helps support revenue and earnings growth, in particular when production costs are rising, as is currently the case.

85%



ASML now has a more than 85% market share thanks to its more ADVANCED TECHNOLOGY

WHERE DOES PRICING POWER COME FROM?

Companies with pricing power generally differentiate themselves through at least one of the following factors:

- A monopolistic/oligopolistic or dominant position in their market;
- A strong brand image;
- Patents or strong capacity for innovation;
- Captive markets/customers or a unique offering with few alternatives.

Below we provide a few particularly good examples of companies that possess these traits:

MONOPOLIES/OLIGOPOLIES OR DOMINANT POSITIONS

The social networks are a perfect illustration of an oligopolistic market. In the United States, two companies have established dominant positions in social networks: Facebook and Alphabet. As a result, these companies dominate the global ad space since digital media currently represent nearly two-thirds of advertising.

In credit cards, Visa and MasterCard have created a sort of duopoly over the years, and the competition between these two actors seems to have lessened, in particular with respect to the prices they charge.

Turning to European companies, ASML, the global leader in lithography systems for the semiconductor industry, is an excellent example. It has an 85% share of the global market and a de facto monopoly in the most advanced technology (EUV, or Extreme Ultra Violet). While not as dominant, other European companies have significant market shares which give them excellent price-setting power, such as Legrand in electrical equipment (Chart 18). Vinci and Ferrovial are also good examples due to their motorway concession businesses.

Revenues in the LUXURY GOODS sector have grown by nearly 10%

STRONG BRANDS

When it comes to companies with strong brands, Europe is clearly very well positioned with its luxury goods groups, such as Hermès, LVMH (Louis Vuitton, Christian Dior, etc.), Kering (Gucci, Yves Saint Laurent, etc.), and Richemont (Cartier, Van Cleef & Arpels, etc.), as well as its consumer goods companies (L'Oréal, Pernod Ricard, Diageo, Remy Cointreau, Campari, etc.).

Apple is a US example of the brand factor. It is in a unique position as it is both a tech company and a luxury goods player. It has strong name recognition and very loyal customers who make sure that every new version of the iPhone is a phenomenal success.

INNOVATIONS AND PATENTS

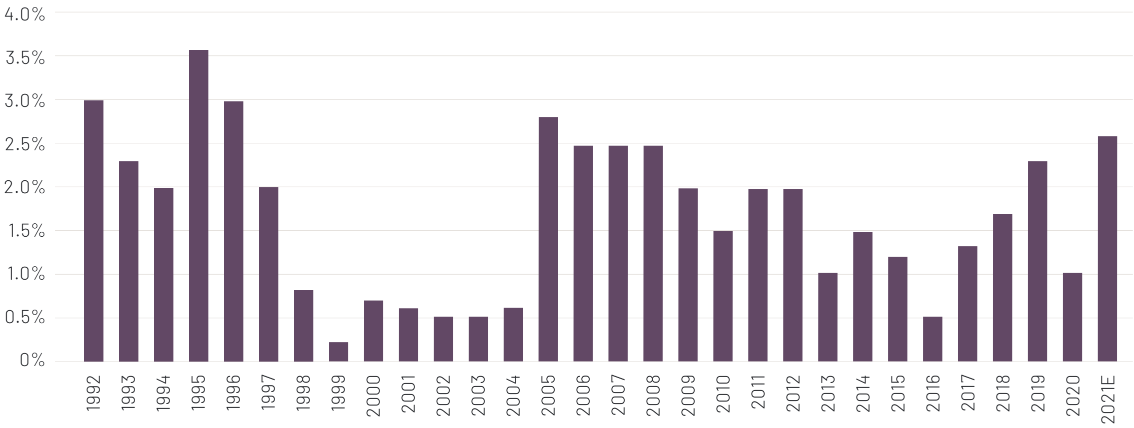
From an innovation perspective, Europe's pricing power leaders are mostly in the healthcare sector (Roche, Novo Nordisk, Siemens Healthineers, Essilor, etc.), although the United States is no laggard either. Take, for example, Pfizer's patent for its COVID-19 vaccine which enabled it to achieve rapid dominance around the world.

The industrial segment is also known for its innovation capacity, with European companies such as Sika in construction chemicals, SIG in packaging, and Ceres Power and ITM in electrolysers, etc. In the United States, the same is true for Intuitive Surgical, the largest robotics company in the world. With its da Vinci robot, it remains a key player in its sector more than 10 years after the robot's launch. The patent includes replacement parts and accounts for more than 70% of its revenues.

CAPTIVE CUSTOMERS OR A UNIQUE OFFERING WITH FEW ALTERNATIVES

Being indispensable to its customers or one of only a few alternatives also ensures strong price-setting ability. Examples include software companies (SAP, Dassault Systèmes, etc.), pharmaceutical suppliers (Sartorius Stedim) and groups that supply ingredients to the beauty cosmetics and agri-food industries. These ingredients may represent a tiny fraction of production costs but have a significant impact on the end product (e.g. fragrances and flavours supplied by Symrise, Givaudan and Kerry).

CHART 18: LEGRAND'S ANNUAL PRICE INCREASES, %



Note: For more than 30 years, Legrand has been able to systematically increase its prices regardless of the economic climate.
Source: Deutsche Bank, company data, Indosuez Wealth Management.

Microsoft transitions from a model with LESS THAN 10% recurring revenues 20 years ago to NEARLY 70% TODAY

One increasingly common way to "build customer loyalty" is through subscription models, the best example of which is none other than Microsoft. The world's largest software company successfully changed its revenue recurrence by transitioning from a model with less than 10% recurring revenues 20 years ago to nearly 70% today. The world's second-largest software company, Adobe, operates almost exclusively on a subscription model and its products significantly dominate the underlying market.

The subscription model is particularly well developed in the financial data industry. Within this group, MSCI has a nearly 95% recurring revenue rate, and its dominant position is a prime example as it counts 19 of the 20 largest asset managers among its customers. S&P Global and NASDAQ are other typical examples of these themes. These companies, whose customers are basically captive due to a lack of alternatives, have strong bargaining power to implement subscription increases.

Pricing power can also be more cyclical or temporary, unlike the previous criteria which represents a more structural advantage.

Some groups, for example, enjoy a favourable pricing environment due to strong end demand, like the digital transformation of products and companies (Cap Gemini, Infineon, ST Microelectronics), energy savings (Saint-Gobain, Kingspan), and recycling (Tomra).

Lastly, while not typically considered pricing power, other factors can be key to coping with rising production costs. In the industrial segments, this can be achieved through productivity gains or economies of scale. For other sectors, it can be an almost structural advantage, like in IT/software where there are virtually no commodity purchase costs and the number of employees is generally very limited.

In conclusion, pricing power is a strong differentiator, particularly against the backdrop of pricing pressure and higher overall costs. For companies, it creates the margin resilience that underpins sustainably higher valuation multiples; for investors, it has become a key stock-picking factor.

Note: the companies mentioned here are cited for illustration purposes and do not constitute investment recommendations.

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ARE CORPORATE MARGINS AT RISK?

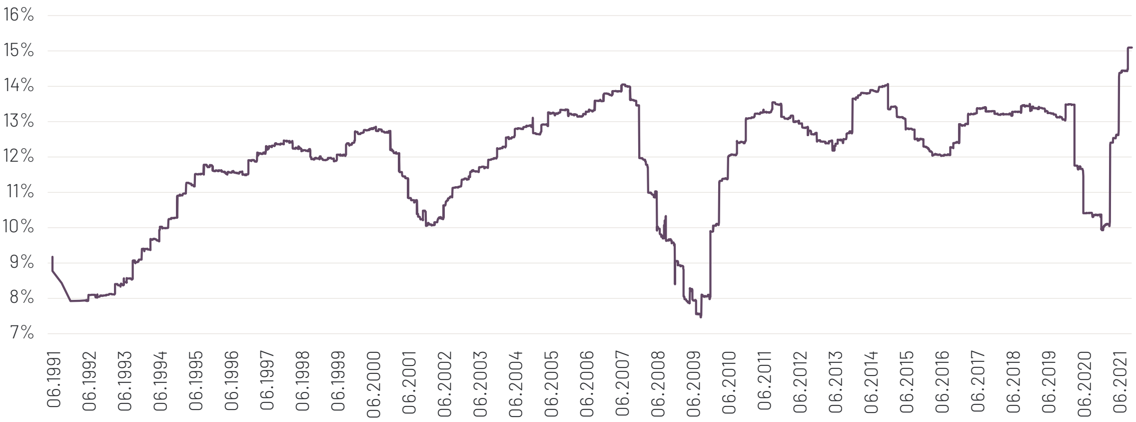
Aggregate net margin of **12.8%** in Q3

Financial headlines have been dominated in recent weeks by ominous news about supply woes and wage pressures. However, this alarming view has not been borne out by companies' third-quarter earnings reports, as they appear to be passing higher production costs on to their end consumers. We expect the headwinds cited in the media to normalise in a future post-COVID-19 world.

Unsurprisingly, US companies' operating margins held up relatively well despite higher wage costs, the rise in commodities, and supply chain woes (Chart 19).

The third quarter was characterised by an aggregate net margin of 12.8%[20], close to the record levels posted in the first and second quarters of 2021, and providing support to the equity rally.

CHART 19: S&P 500 OPERATING MARGIN, QUARTERLY DATA, %



Source: Bloomberg, Indosuez Wealth Management.

20 - DataTrek Research and BofA Global Research.

The weight of energy in the cost base is only
5%
on average

COST INCREASES PASSED ON TO CONSUMER PRICES

It is therefore evident at this stage that companies have managed to pass higher costs on to consumer prices, thereby protecting their earnings from erosion due to mounting cost pressure. In addition, the weight of energy in companies' cost base is only 5% on average and the increase in these expenditures has therefore been largely offset by productivity gains (Chart 20).

Inflation was the most frequent topic of discussion on companies' third-quarter earnings calls, along with its impacts on labour, transport, commodities, and supply chains.

What would happen if this inflation were not transitory but continued to rise and became structural?

Inflation in the United States is now more than twice the Fed's target. However, the Chair of the Federal Reserve, Jerome Powell, stated in early November 2021 that the supply bottlenecks would likely ease, thereby reducing inflationary pressures. In his opinion, this is the "most likely" scenario.

In this discussion around transitory or runaway inflation, we are reluctant, for now, to adopt a stagflationary scenario as our core assumption.

As has happened in the recent past, new technologies, such as artificial intelligence, blockchain, and robotics will help control inflationary pressures in the medium to long term.

It is, in fact, difficult to paint a bleak picture when we are seeing a combination of higher consumer spending, significant cash to be deployed, a rapid recovery in the job market, financial assets hitting new highs, and a boom in corporate earnings.

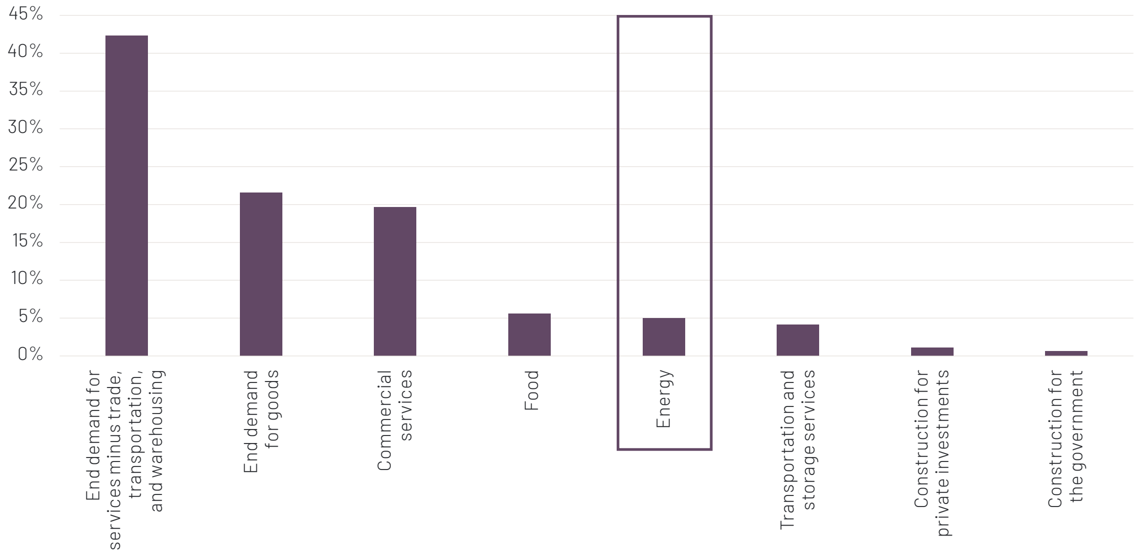
SLOWDOWN IN MANUFACTURING ACTIVITY

Nevertheless, the latest Institute for Supply Management (ISM) reports point to a slowdown in manufacturing activity in response to persistent tensions in the supply chain. The Chair of the Committee stated that "companies continue to deal with an unprecedented number of hurdles to meet increasing demand".

It should be noted, however, that the economy was comparatively less affected by higher energy prices, since world GDP is two times less dependent on oil than it was in the 1970s[21].

Similarly, US companies are, on a relative basis, 70% less labour-intensive than in the 1980s[22].

CHART 20: BREAKDOWN OF PRODUCTION COSTS, %



Source: Bloomberg, Indosuez Wealth Management.

21 - The energy required to support output, Deutsche Bank Research.
22 - BofA Global Research.

They are still capable of absorbing higher wage costs and can re-hire young workers for lower pay than that of the senior employees who are leaving their current jobs[23]. The weight of wages in S&P 500 companies' revenue is only 13% on average, up 4.1% year-on-year (Chart 21).

In conclusion, profit margins and future equity performances should withstand any new and more sustainable inflationary pressures, as companies are benefiting from their ability to pass costs on to prices.

Automation and digital adaptation will play a key role, as companies increase their investments to adjust to a new consumer landscape and improve efficiency.

These secular trends will lead to additional efficiency gains. Businesses and entrepreneurs will therefore be highly incentivised to find new solutions and gain access to the latest productivity-boosting automations and technologies.

MARCO PAOLUCCI
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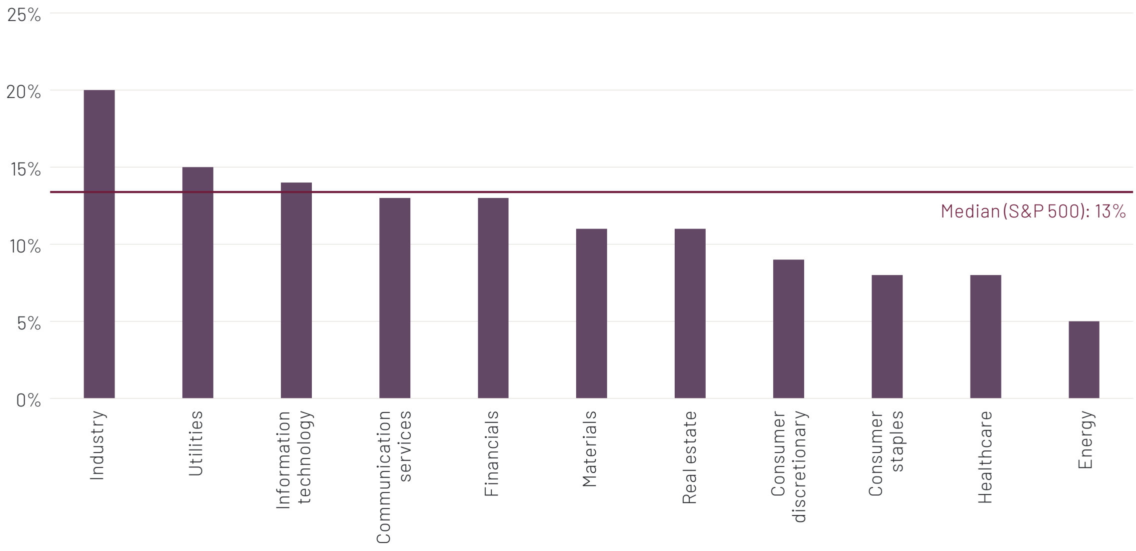
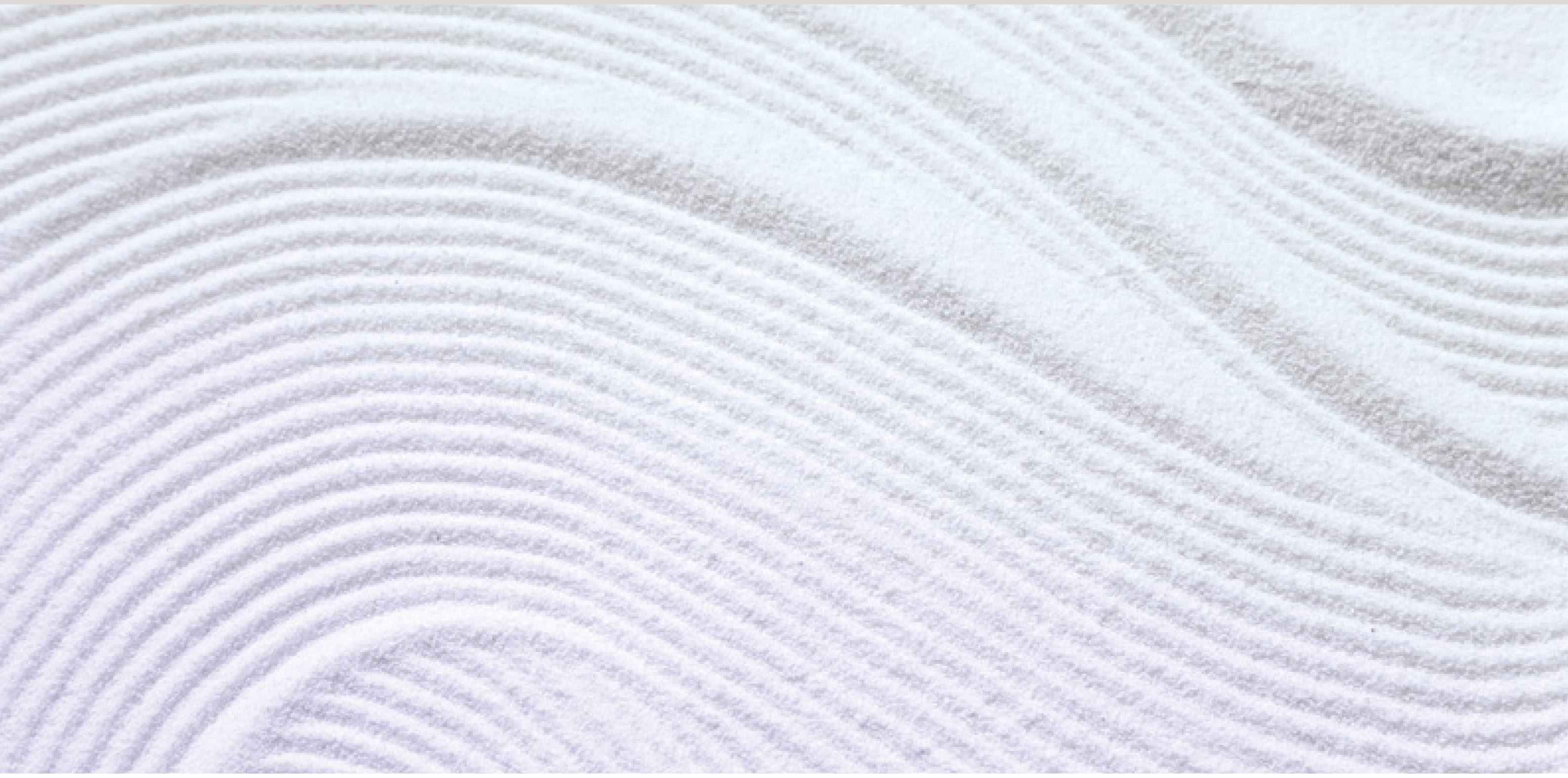
CHART 21: IMPLICIT WAGE COSTS AS % OF REVENUES



Source: Bloomberg, Indosuez Wealth Management.

23 - Bloomberg Business News.

IS INFLATION A SUPPORT FACTOR FOR THE DOLLAR AND GOLD?



Economic theory tells us that if a country is facing higher inflation than its counterparts, its currency should depreciate against other currencies. So if US inflation is at its highest level since 2008, why does the US dollar continue to appreciate against the euro? Conversely, how can we explain the decline in gold, which has traditionally been viewed as a hedge against inflation? Let's unravel this double paradox.

When Joe Biden was elected, many strategists predicted that the dollar would fall against the euro in 2021, particularly if the Democrats won a majority in the Senate. Between the inflationary effect of the *stimulus* plan and the double deficit, there were plenty of reasons to think this would happen, and yet the opposite occurred during the year, after the confirmed weakness of the dollar against the euro above 1.23 when the Democrats won the two Georgia Senate seats in early January 2021.

We believe there are several reasons why the dollar strengthened during 2021.

First, the dollar benefited from a macroeconomic *momentum* gap versus the Euro Area. The first quarter of 2021 was characterised by stronger vaccination *momentum* in the United States while the Euro Area struggled to procure vaccines. This difference in *momentum* was compounded by the *stimulus* plans put forward by the new US administration. In this phase, the dollar rallied to 1.1750, before the acceleration in the European vaccination campaigns brought the single currency back up against its US counterpart.

Investors thought the FED WOULD RAISE ITS KEY RATES BY FALL OF 2022 and thereby support the currency

DOLLAR SUPPORTED BY EXPECTATIONS OF A FED POLICY CHANGE

Next, the greenback benefited from market expectations of a change in the central bank's policy. The Fed faced a dilemma: fight inflation, which was expected to be about 5 to 6% in 2021, or support a job market that had not yet returned to its pre-COVID-19 crisis level. Starting in the spring, the acceleration in inflation led the market to expect a monetary policy normalisation, whose contours Jerome Powell gradually began to outline in June. While the Fed Chair said repeatedly that an asset purchase tapering did not mean a rate hike, investors were not convinced and thought instead that the Fed would raise its key rates by fall of 2022 and thereby support the currency. Investor expectations were also fuelled in September by the Fed's forecasts, which showed that half its members expected rate hikes starting at the end of 2022. It was therefore no coincidence that, in that month, the dollar strengthened from 1.19 to about 1.15 against the euro (Chart 22).

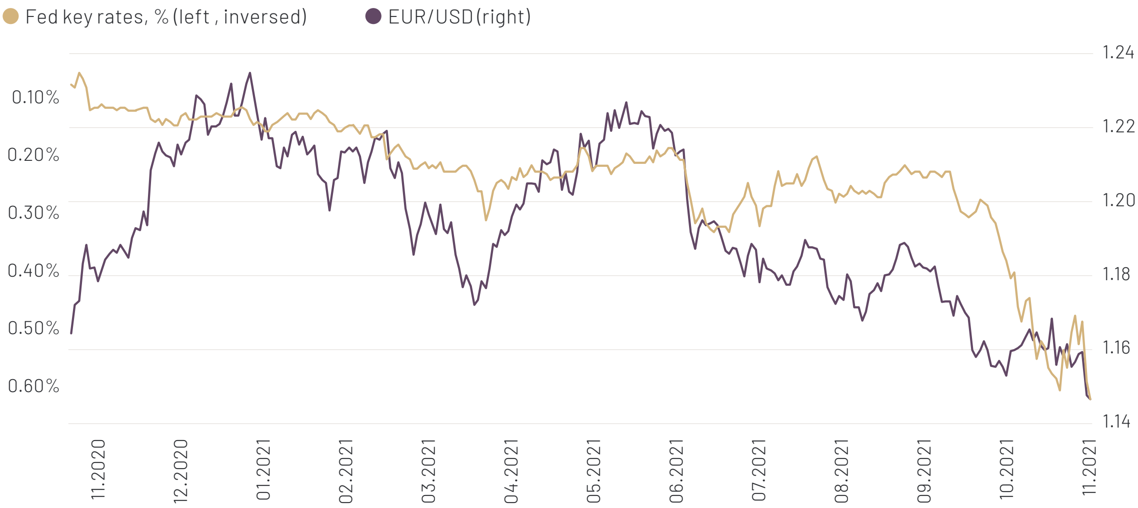
Lastly, the dollar also benefited from its safe-haven status. In periods of stress, investors tend to liquidate risky assets, such as emerging country currencies, and retreat to vehicles they think are safer, such as the US dollar, the Swiss franc, and gold.

So, in 2021, several drivers of uncertainty combined to temporarily support the dollar: the evolution of the COVID-19 pandemic, the real estate crisis in China involving Evergrande, and the debate about raising the debt ceiling in the United States.

In fact, the dollar strengthened mostly against the euro, which suffered from the absence of rate hike expectations in 2022-2023, and against emerging country currencies (excluding China). The situation of the latter currencies clearly shows that a currency's strength depends primarily on the credibility of its central bank. One example is Brazil, which is fighting inflation by implementing very sharp key rate hikes. Its currency has plunged against the dollar despite higher carry and real rates that are expected to return to positive territory next year.

This year, the only currencies that are holding steady or appreciating against the dollar are those of commodity-exporting countries (exporters of inflation), along with the Chinese currency which combines low inflation with a positive real interest rate.

CHART 22: FED KEY RATE EXPECTATIONS



Source : Bloomberg, Indosuez Wealth Management.

Gold's appeal is reflected in REAL RATE TRENDS

Lastly, although inflation is an important indicator for currency trends, the inflation/depreciation relationship currently does not hold true for the dollar due to strong expectations of a rate hike (Chart 23).

GOLD, MORE OF A HEDGE AGAINST NEGATIVE REAL RATES THAN AGAINST INFLATION ITSELF

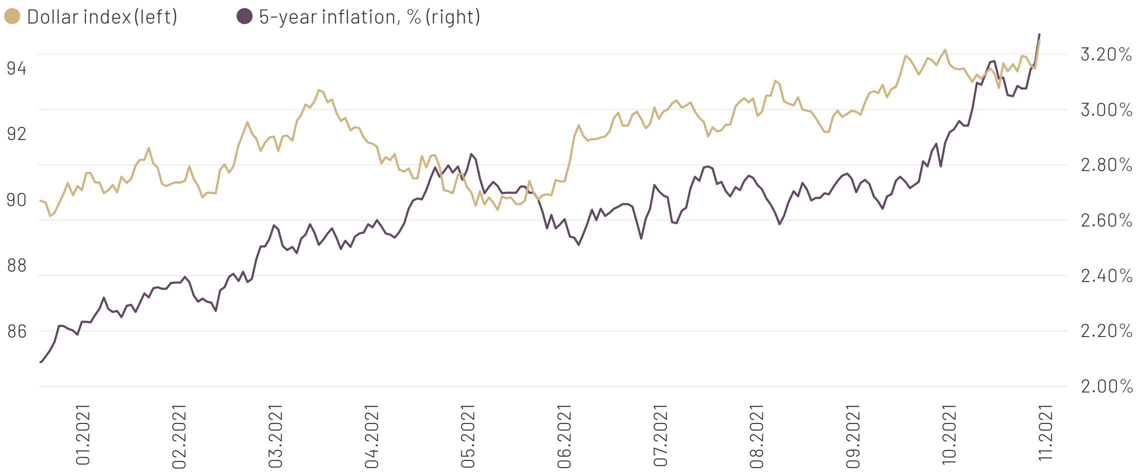
As for gold, which is often used for its role as a hedge against inflation, one might ask why its price is not higher.

First, gold price consolidation can be explained in part by the appreciation of the dollar, its reference currency, and higher Treasury yields.

Gold's appeal is reflected in real rate trends: in the summer of 2020, when gold hit a new all-time high, US real rates were at their lowest level (Chart 24).

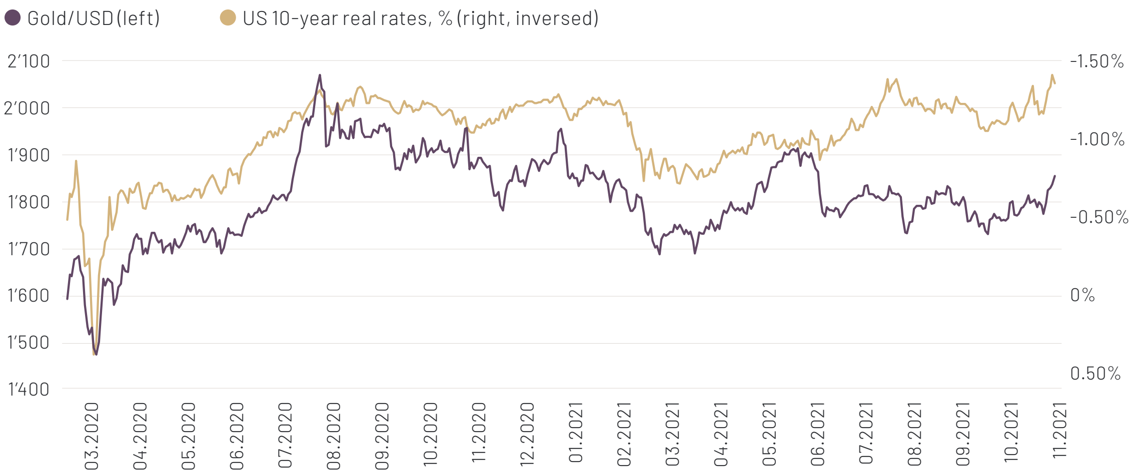
However, in 2021, the rise in inflation was offset by an increase in US long-term rates, which muddied the waters for investors.

CHART 23: DOLLAR INDEX AND INFLATION



Source: Bloomberg, Indosuez Wealth Management.

CHART 24: GOLD AND US 10-YEAR REAL RATES



Source: Bloomberg, Indosuez Wealth Management.

We should also bear in mind that gold is an asset that has no yield. In the context of the post-COVID-19 recovery, investors have forsaken gold in favour of other riskier – and therefore more attractive – asset classes such as equities.

Lastly, flow dynamics also explain the gold trend. At the end of September 2021, demand for gold had fallen by 9% compared with 2020 despite an increase in central bank purchases. Several emerging countries followed in China's and Russia's footsteps and increased their gold reserves to diversify away from the dollar.

In conclusion, looking ahead to 2022, the year should be characterised by a gradual decline in inflation and the ongoing normalisation of the Fed's policy. We would expect the dollar support factors to persist and limit gold's upside potential. The metal could retain some appeal as a hedge against an alternative scenario in which inflation surprises and interest rates are maintained at their current levels. Political uncertainties around the French elections could also temporarily support the dollar against the euro in spring 2022.

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04 | Global presence

OUR STORY

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05 | Glossary

Basis point (bp): 1 basis point = 0.01%.

Blockchain: A technology for storing and transmitting information. It takes the form of a database which has the particularity of being shared simultaneously with all its users and generally does not depend on any central body.

BLS: Bureau of Labor Statistics.

BNEF: Bloomberg New Energy Finance.

Brent: A type of sweet crude oil, often used as a benchmark for the price of crude oil in Europe.

CPI (Consumer Price Index): The CPI estimates the general price level faced by a typical household based on an average consumption basket of goods and services. The CPI tends to be the most commonly used measure of price inflation.

Deflation: Deflation is the opposite of inflation. Contrary to inflation, it is characterised by a sustained decrease in general price levels over an extended period.

Duration: Reflects the sensitivity of a bond or bond fund to changes in interest rates. This value is expressed in years. The longer the duration of a bond, the more sensitive its price is to interest rate changes.

EBIT (Earnings Before Interest and Taxes): Refers to earnings generated before any financial interest and taxes are taken into account. It takes earnings and subtracts operating expenses and thus also corresponds to non-operating expenses.

EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortisation): EBITDA takes net income and adds interest, taxes, depreciation and amortisation expenses back to it. It is used to measure a company's operating profitability before non-operating expenses and non-cash charges.

ECB: The European Central Bank, which governs the euro and Euro Area member countries' monetary policy.

Economic Surprises Index: Measures the degree of variation in macro-economic data published versus forecasters' expectations.

Economies of scale: Decrease in a product's unit cost that a company obtains by increasing the quantity of its production.

EPS: Earnings per share.

ESG: Non-financial corporate rating system based on environmental, social and governance criteria. It is used to evaluate the sustainability and ethical impact of an investment in a company.

Fed: The US Federal Reserve, i.e. the central bank of the United States.

FOMC (Federal Open Market Committee): The US Federal Reserve's monetary policy body.

GDP (Gross Domestic Product): GDP measures a country's yearly production of goods and services by operators residing within the national territory.

Gig economy: system characterised by flexible, temporary or freelance jobs.

IEA: International Energy Agency.

IMF: The International Monetary Fund.

Inflation breakeven: Level of inflation where nominal bonds have the same return as inflation-linked bonds (of the same maturity and grade). In other words, it is the level of inflation at which it makes no difference if an investor owns a nominal bond or an inflation-linked bond. It therefore represents inflation expectations in a geographic region for a specific maturity.

Inflation swap rate 5-year, 5-year: A market measure of what five-year inflation expectations will be in five years' time. It provides a window into how inflation expectations may change in the future.

IPPC: The Intergovernmental Panel on Climate Change.

IRENA: International Renewable Energy Agency.

ISM: Institute for Supply Management.

Japanification of the economy: Refers to the stagnation the Japanese economy has faced in the last three decades, and is generally used to refer to economists' fears that other developed countries will follow suit.

Metaverse: A metaverse (portmanteau of meta and universe) is a fictional virtual world. The term is regularly used to describe a future version of the internet where virtual, persistent and shared spaces are accessible via 3D interaction.

OECD: Organisation for Economic Co-operation and Development.

Oligopoly: An oligopoly occurs when there is a small number of producers (supply) with a certain amount of market power and a large number of customers (demand) on a market.

OPEC: Organization of the Petroleum Exporting Countries; 14 members.

OPEC+: OPEC plus 10 additional countries, notably Russia, Mexico, and Kazakhstan.

PMI: Purchasing Managers' Index.

Policy-mix: The economic strategy adopted by a state depending on the economic environment and its objectives, mainly consisting of a combination of monetary and fiscal policy.

Pricing power: Refers to the ability of a company or brand to increase its prices without affecting demand for its products.

Quantitative easing (QE): A monetary policy tool by which the central bank acquires assets such as bonds, in order to inject liquidity into the economy.

SEC (Securities and Exchange Commission): The SEC is an independent federal agency with responsibility for the orderly functioning of US securities markets.

Spread (or credit spread): A spread is the difference between two assets, typically between interest rates, such as those of corporate bonds over a government bond.

Secular stagnation: Refers to an extended period of little or no economic growth.

SRI: Sustainable and Responsible Investments.

Uberisation: Term derived from the name of US company Uber which develops and operates digital platforms that connect drivers and riders. It refers to a new business model that leverages new digital technologies and is part of the sharing economy, insofar as it puts customers in direct contact with service providers, at a reduced cost and with lower prices.

VIX: The index of implied volatility in the S&P 500 Index. It measures market operators' expectations of 30-day volatility, based on index options.

WTI (West Texas Intermediate): Along with Brent crude, the WTI is a benchmark for crude oil prices. WTI crude is produced in America and is a blend of several sweet crude oils.

WTO: World Trade Organization.

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