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The Road Back to the 70s Implications for Investors

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CIO Letter

Pascal
BLANQUÉ
Group Chief Investment Officer

History shows that the economy and financial markets are dominated by long-term regimes that at some point come to a break point, where one regime gives way to a new one. This shift may not be easy to detect. Trapped in their comfort zones, with a short-term perspective, few may see it coming.
The arrival of Paul Volcker at the helm of the Federal Reserve, after a long period of inflationary pressure, symbolically brought to a close the macro-financial regime of the 1970s (the Great Inflation) and prepared us for the regime we are leaving today (low inflation, low volatility regime), albeit passing through a "bubble and burst" phase in the 1990s. A change in regime is brought about when the imbalances that it causes are no longer tolerated by society. Such a change is also and always one of the institutions (central banks, political parties, etc.) that structure the regime itself. Aware that every force produces a counterforce, like the movement of a swinging pendulum, we see the Volcker sequence now ending.

We are seeing cracks in the current macro-financial regime starting to show. Many challenges are escalating, including ballooning debt in the economic system, the impasse central banks face in abandoning their extraordinary monetary stimulus, rising protectionist pressures and worrying income inequality. Capitalism and profit have not been as unpopular as they are today since the 1970s, and the conditions for a road back to a similar macro-financial regime are materialising.

Intellectual victory and academic consensus around specific topics also always precede regime shifts. Today, with inflation progressively forgotten as a threat, the idea has spread that the current high debt levels are not an absolute obstacle to budgetary stimulation, while room for manoeuvre exists and could be used for focused policies.
With safe interest rates in the US below growth rates, an historical norm expected to continue to hold, "public debt may have no fiscal cost", according to Blanchard, as the ratio of debt to GDP could decrease over time.
In addition, the welfare costs associated with public debt reducing capital accumulation may prove more limited than feared, as the marginal productivity of capital could be lower than expected. Consequently, a low risk-adjusted rate of return to capital would justify the use of fiscal expansion and debt to finance public investment. Taken to the extreme, the so-called Modern Monetary Theory (MMT) suggests that modern advanced economies should always be able to avoid a default event on their sovereign debt in their domestic currency, as central banks should be able to repay public debt by printing domestic currencies. Under MMT, fiscal and monetary policy roles may switch as MMT assumes that expansionary fiscal policy could be financed by money creation (Mitchell et al.). The temptation may be growing among economies stuck at the zero lower bound and/or faced with a risk of recession.
As Blanchard notes, some relate these low rates to the "secular stagnation" thesis, i.e., structurally high savings and low investment (Summers) or higher demand for safe assets (Caballero et al.). The fact that the natural interest rate of equilibrium, though not observable, has arguably shifted significantly downward in the private sector (Summers), paves the way for "greater tolerance of budget deficits (and) unconventional monetary policies".
This set of hypotheses comes with considerable uncertainty. For example, liquidity discounts reflecting distortions such as financial repression forces may have played a role. Furthermore, the fact that investors attach a low probability to a significant pick-up in inflation and/or rates (looking at 10-year inflation indexed bonds, there is a minimal 10-15% market implied probability of seeing rates higher than 200bps in the five years to come) does not mean they are right. The point here is that there are mounting intellectual forces challenging traditional thinking. Though they may include some kind of a "bias of confirmation", right or wrong, they point to potential changes in policy.

The next recession could be the crossover point for a regime shift. A retreat in globalisation, the inflationary effects of protectionism and the politicisation of financial and economic variables could turn the clock back towards the 1970s.

In the following pages, we provide investors with some guidelines for portfolio construction, depending on different inflation scenarios. Implications for investors will be, in particular, in terms of asset allocation, as the expected returns and correlation dynamics change in different inflation regimes. In (hyper) inflationary regimes, in fact, both bonds and equities have not delivered well in real terms and have exhibited higher correlation, while real assets such as commodities, real estate and infrastructure have delivered better risk-adjusted returns. Therefore, we believe it is crucial for investors to rethink their strategic asset allocation, including exposure to real assets, and be ready to adjust to the different inflation scenarios that could materialise in the future.

In addition, as inflation is expected to come back as a consequence of (de) globalization, strategies based on geographical/ regional diversification will be back in focus, while the ones exposed to globalization, which benefited the most in the last three decades, will become less effective.

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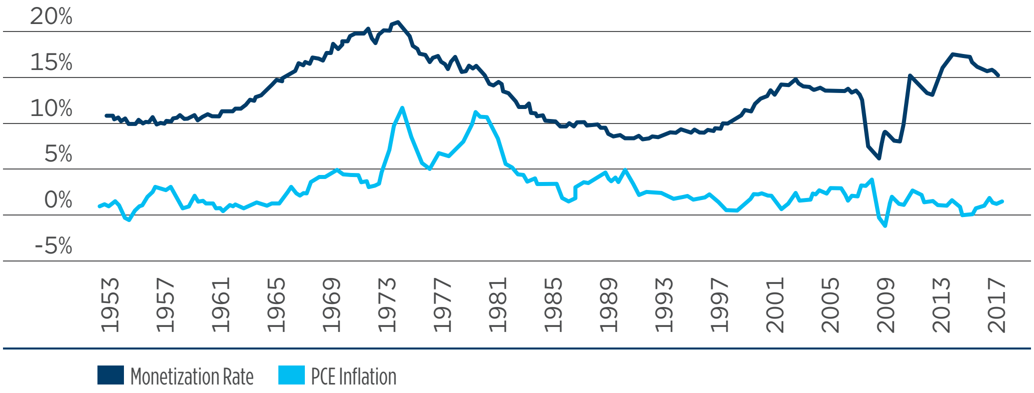
What a regime shift means: The example from the 70s to the 90s

"The 70s were a time of severe energy shortages, economic recessions and rising unemployment."

The backdrop of the 1970s consisted of a prevailing socialist ideology and a sharing of added value favouring salaries versus profit, in an environment of unionist mobilisation and social contestation. This was a period of severe energy shortages, economic recessions and rising unemployment. Central banks, subjugated by political powers, were directly monetising ballooning budget deficits. Soaring oil prices added to this complex situation.

Figure 1: Monetisation rate and PCE inflation in the US



Source: Federal Reserve Bank of Saint Luis on Federal Reserve Board of Governors and Bureau of Economic Analysis data. The act of converting high-interest debt into money, through the increase of low-interest reserves is labelled "debt monetisation". The figure above plots the percentage of debt held by the Federal Reserve—the monetisation rate—against personal consumption expenditures (PCE) inflation. https://www.stlouisfed.org/on-the-economy/2018/april/debt-monetization-then-now

"Macro-economic imbalances took the form of goods and services inflation."

Macro-economic imbalances took the form of goods and services inflation. The risk premia in financial markets adjusted to this regime: this was a dark decade for investors, with only cash and real assets offering refuge.

The damage caused by inflation outstripped the supposed benefits. Inflation has significant effects on income distribution, first, because it is fundamentally a differential phenomenon and certain prices rise or fall more than others; second, because different income groups have different sensitivities to price increases (on the consumption basket of lower income groups, for example, food and energy inflation weighs more than on those with higher incomes).

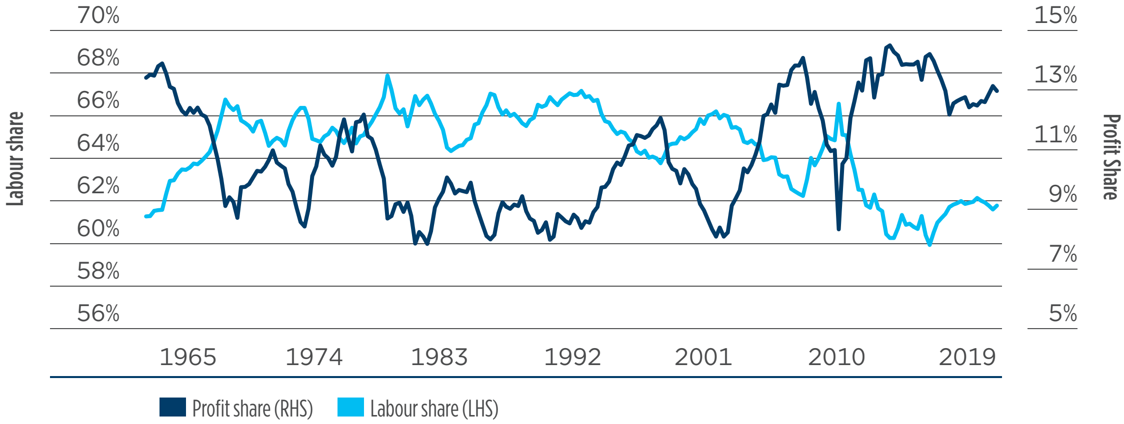
"When inflation was no longer tolerated by society, Volcker was appointed as the chair of the Fed, and this triggered a regime shift."

At some point, inflation, in the form of goods and services inflation, was no longer tolerated by society – and ultimately the institutions representing society (the political systems, governments, central banks) had to reflect this change. Volcker was appointed as the chair of the Federal Reserve in August 1979, Fed rates doubled to a peak of 20% in March 1980, and this was the time for a regime shift.

After a period of transition, during the 1990s a new regime took shape, sometimes called that of shareholder or patrimonial capitalism: the goal of corporations was to maximise shareholder value, leading to the dominance of profit vs labour against a backdrop of deregulation ideology and globalisation.

"During the 90s, a new regime took shape, sometimes called that of shareholder or patrimonial capitalism."

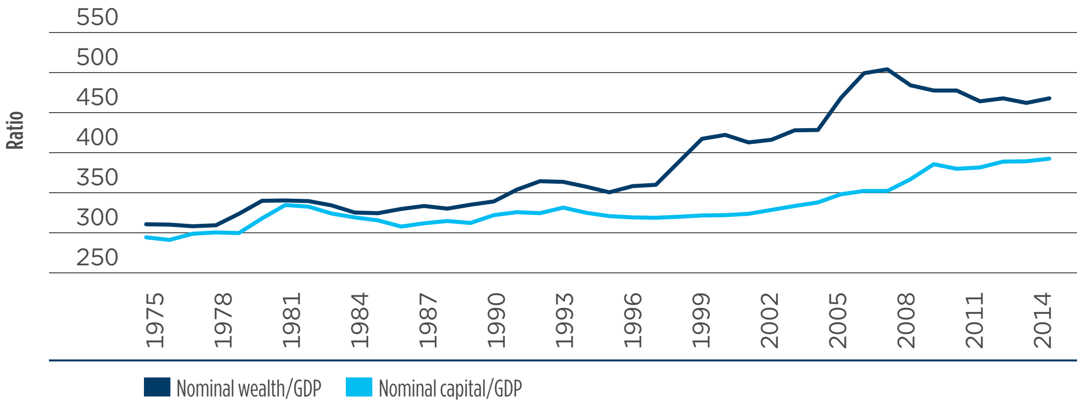
Figure 2: Profit and labour share of GDP in the US



Source: Amundi, BEA, data as of 3 April 2019.

As potential growth and productive investment embarked on a phase of decline, private debt increased to compensate for the missing growth, laying the foundations for economic stagnation. The gap between financial wealth and productive wealth widened substantially, reaching a peak just before the great financial crisis.

Figure 3: The widening gap between financial wealth and productive wealth



Source: IMF, World Economic Outlook, April 2019.

"The persistent low interest rates environment has been the premise for another form of inflation: asset price inflation."

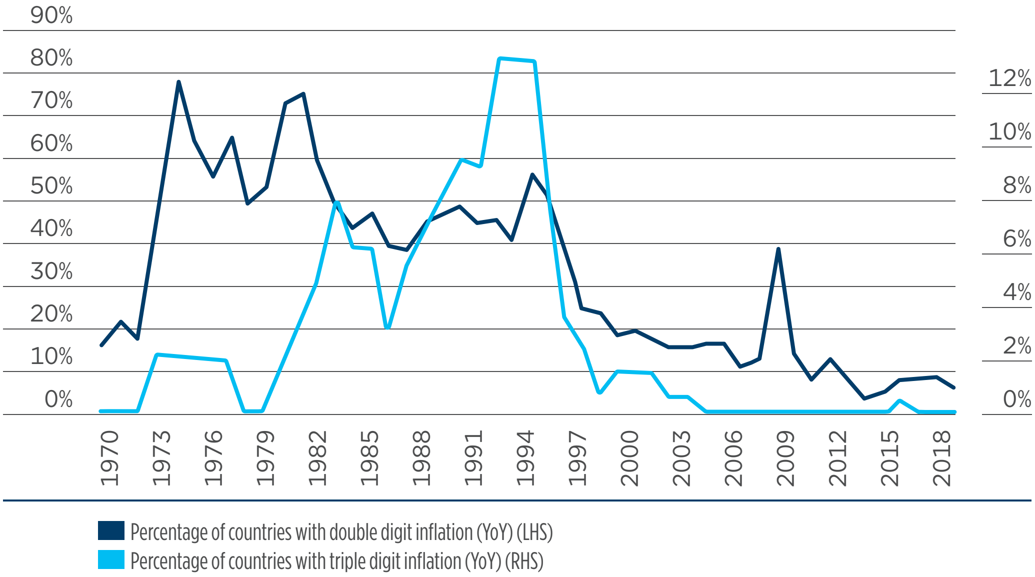
On the inflation front, classic (goods and services) inflation did not materialise and the model of independent central banks was perceived as credible in preventing the return of inflation. However, **the persistent low interest rates environment has been the premise for another form of inflation**: asset price inflation. All periods of weak inflation/weak growth with low volatility have been followed by higher financial volatility as they have encouraged artificial paradises.
Debt monetisation did not show up in the form of classic inflation (see Figure 1). The financial markets, and not the markets for goods and services, can be the receptacles of unwanted cash. In fact, from 1995, the valuations of numerous financial markets departed from classical paths.
Indeed, in this regime, there have been those who have increasingly spoken out (with louder and louder voices) to condemn the harm inflicted by asset price inflation: when bubbles inflate, they strengthen wealth inequalities and when they burst, generate deflationary spirals and recessions, as well as opening up periods of interventions by public authorities. However, central banks do not have the mandate this time, or not yet, to fight against this particular form of inflation. This means that central banks have embraced an asymmetric position towards asset prices – cutting rates when they fall, but being unwilling to raise rates when they rise sharply. And now that the monetary room for manoeuvre seems to have been exhausted, they are likely to have recourse to even more aggressive unconventional policies at the next setback in growth and/or asset prices.

Where are we today? A possible new regime shift

"Today we are in a regime of low growth and low goods and services inflation."

As of today, we find ourselves in a sort of post-crisis deflationary regime of rather low growth and low inflation, accompanied by a risk premium regime reflecting these trends (low interest rates, asset inflation), a similar departure point as the 1990s. Over the last 30 years, the percentage of countries with double- or triple-digit inflation has significantly dropped.

Figure 4: The death of high inflation



Source: National Sources, Amundi Research.

"Potential sources of inflation could come from direct monetisation of budget deficits such as in the 70s, a retreat from global trade/ protectionism and a rebalancing of policies in favour of labour."

It is tempting to think that we are reverting back, in some aspects, to the long-term trends of weaker growth and low-stable inflation after the distortions of inflation (1970s regime) then the debt-fuelled artificial growth and asset bubble (1990s regime). Various aspects of Gordon's thesis of secular stagnation add to evidence for this, in particular, lower productivity growth, weaker growth potential and an ageing population.
But we could just be in the aftermath of a global "balance-sheet recession", a phrase coined by R. Koo, that has been engineered by a debt crisis, or more challengingly, we could be heading into a more long-lasting debt deflationary phase (I. Fisher). The jury is still out.

We consider in the following developments a shift towards an inflationary regime – possibly going first through a financial crisis and/or recession – where the sources of inflation would include:

1. Full-blown direct monetisation of budget deficits as consensus builds to have recourse to fiscal stimulation (inflation is always a monetary phenomenon);
2. A retreat from global trade/protectionism; and
3. A rebalancing of social and political support in favour of labour.

Risk premia will move well in advance of effective shifts as markets test the new lines. Investors should be prepared for early action.

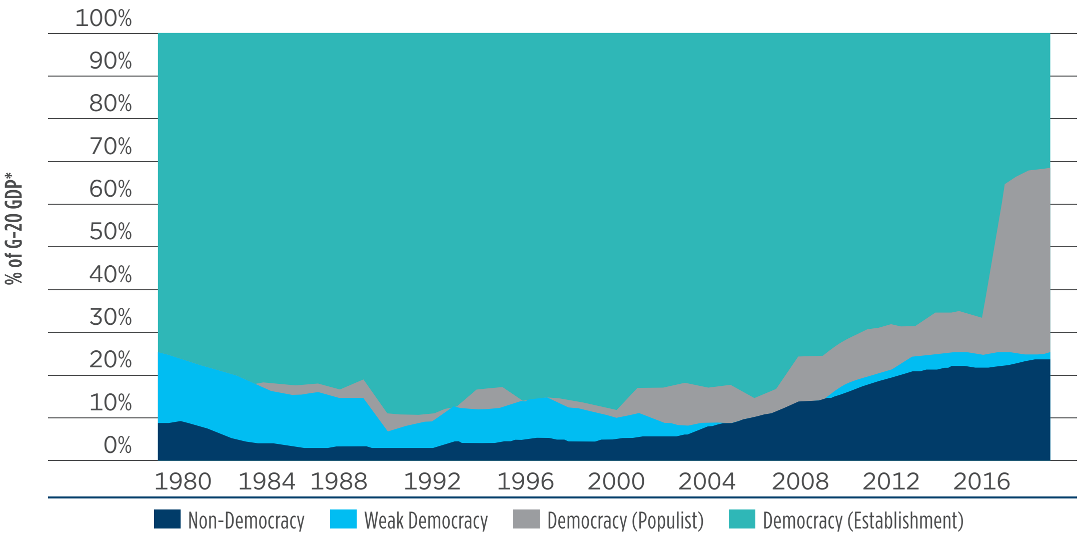
"The cracks in the current regime are starting to proliferate."

The cracks in the current regime are starting to proliferate, and one can observe a slow alignment of planets for a regime shift: social unrest bringing people into the streets and the emergence of new political parties and challenges to the institutions (political and financial) that are considered responsible for the discontent. Various forms of dissatisfaction are clearly visible and a desire to break with the past is rising among populations. At the same time, the changing political landscape is painful and divisive; the voice of populism crystallises the case for change, but perhaps imperfectly.

Angst and anger have proliferated in an extended post-crisis period of decent growth. What will happen in times of recession?

"Central banks (especially in the US, the UK and in Japan, less so in the Eurozone) will be increasingly pressured by governments to change their objectives, to move towards so-called fiscal dominance at least, and to embrace a direct budgetary stimulation of growth through debt monetisation."

Figure 5: G-20 GDP by governance



Source: Bloomberg Economics, Freedom House, International Monetary Fund. *Data includes G-20 countries plus Spain. Russia data begins in 1992.

There are different issues at stake now.
First, we could mention central banks (especially in the US, the UK and in Japan, less so in the Eurozone), being increasingly pressured by governments to change their objectives and, in particular, to move towards so-called fiscal dominance, which seeks to privilege the sustainability of debt as a priority. **Central banks are now challenged to use unconventional tools**, i.e., quantitative easing (QE), in pursuit of more aggressive economic stimulation.
Taken to the extreme, QE, a tool forged as an emergency response to the great financial crisis, which to some extent is responsible for the unintended consequences now under scrutiny (surge of financial wealth and inequality, aggressive search for yield in investors' portfolios), could serve from now on to monetise more directly budget deficits. The so-called "portfolio balance and wealth effect" has mostly benefited existing holders of wealth, while impoverishing average pensioners and savers in deposit-like products. **QE 1.0 acted like an unequal tax: QE 2.0 would correct it.**

There is a strong need for infrastructure investments and there is a temptation to finance public spending with debt bought by central banks. Japan has already taken such a step and pressure to do so could quickly rise in the US or in the United Kingdom. Only the Eurozone seems to be "protected" by the strong institutional independence of its central bank, at least for the time being.

"A sharp rise of the income distribution theme is a sign of malaise in the current regime."

Second, we could also see the sharp rise of the income distribution theme, now a key political card to play, with inequality increasingly becoming a sign of malaise in the current regime.

Is there a risk we will experience again the tough regime of the 1990s – bubbles bursting? Not in the immediate future – we do not believe it is possible to get out of the current regime in the blink of an eye, its characteristics will continue to dominate the immediate future. But, from a longer-term perspective, we can imagine similar causes producing similar consequences: we could potentially take the same path as the 90s with its sequence of excess and bubbles. Put simply, a recession will occur at the end of this current cycle, even if at present it seems eternal. This would definitely exacerbate the winds of protest, which recently lead to Brexit and the election of Trump, although these events happened in a relatively benign economic outlook.

"We believe the next recession could put us back on the path of the 1970s."

Could the next recession be the trigger of a regime switch? Yes, we believe this crossover point could put us back on the path of the 1970s.
In the paper *Four investing paradigms for an era of regime shifts (Dec 2017)*, we assessed the possible regimes ahead and their probabilities, in the medium (three-to-five years) and long term (10 years). At that time, we attributed a probability of 20% to a back-to-the-70s regime for the long term, with a 30% probability of a great moderation 2.0 and a 50% chance of a boom and bust as in the 1990s. **We believe that a 1990s scenario of bubble and bust is increasingly likely, and that the end result will most likely (40% probability) be a back-to-the-70s regime.**

Figure 6: Possible regime shifts and related probabilities

	Key features	TODAY	Regime probability		Investment Implications
			Mid-term	Long-term	
Great moderation 2.0	Low, but decent growth Low inflation Slow removal of CB accommodation	✓	30%	30%	Low volatility, slow rise in rates...risk to generate a bubble
Boom and bust as in the '90s	Deregulation with still low rates Rise in leverage and private debt		50%	30%	At the end of the bull market, the bubble burst will cause extreme disruption
Back to the '70s	Fast rise in inflation Protectionism Central Banks behind the curve politically pressured		20%	40%	Challenges for all asset classes in real terms

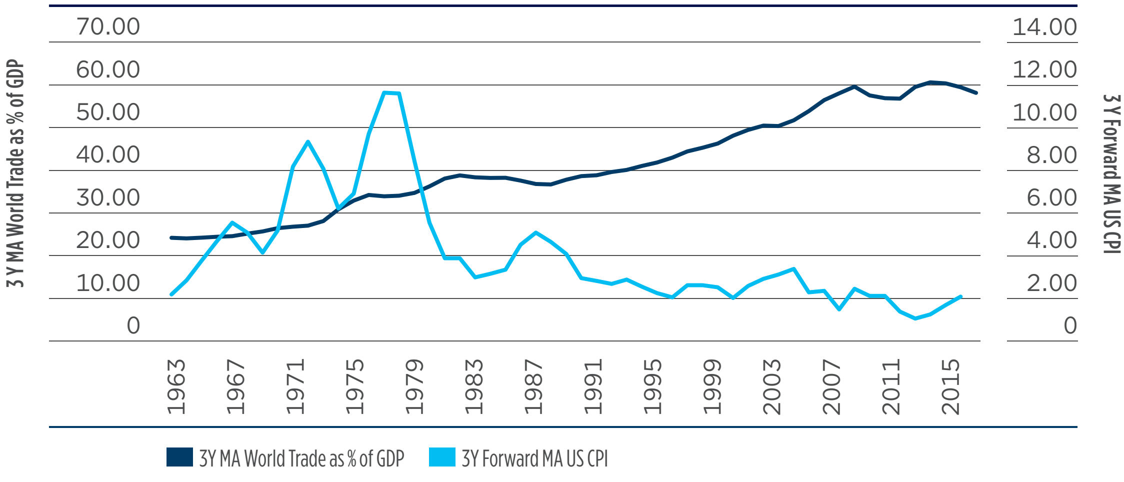
The road back to the 70s

Source: Amundi, as of 25 April 2019.

"A 90s scenario of bubble and bust is increasingly likely and the end result will most likely (40% probability) be a back-to-the-70s regime."

We already see some precursors for this road back to the 1970s. Inflation seems off the radar for now and deflationary forces will continue to prevail in the short term. The seeds of inflation will eventually grow, linked to geopolitical evolutions: indeed, in contrast with the globalisation process of the 90s we are now witnessing a progression of different forms of protectionism and trade wars (M. Carney). The concept of global growth fuelled by trade growth is fading, and global growth is retreating as we are moving towards more autonomous growth drivers with national or regional engines, where the disinflationary effects of globalisation recede. The labour slack which drives wage growth will be a domestic one not a global one.
This means less contribution of global trade to global growth and to disinflation.

Figure 7: Global trade to GDP and US CPI



Source: Amundi elaboration on World Bank data (world trade, world GDP) and Bloomberg (US CPI), as of 25 April 2019.

For investors this means that: (a) global portfolios should be less exposed to global trade factors (investors have been long global trade in the last three decades); and (b) symmetrically, international diversification, impaired by the correlation to a single global trade factor, should prove more effective as this factor fades.

"Financial and economic variables becoming politicised is part of the road back to the 70s."

Financial and economic variables becoming politicised is part of the road back to the 1970s. This is another distinct and decisive feature of globalisation retreating back home. We can certainly see that QE, far from constituting a one-off/exceptional event, is now part of CBs' toolbox, something which will be used in the next recession, and above all will create the temptation to use it for a direct monetisation of budget deficits. While in the current macro-financial regime money is essentially injected into the economy through financial markets – where it can stay trapped, fuelling asset price inflation – the **full monetisation of budget deficits, combined with a rebalancing of social and political forces in favour of labour, could provoke a price-wage loop.**

We can see this in the notion of the low interest rates often associated with the theme of debt sustainability, which brings a political dimension to the debate around financial variables. With QE and its various distortions brought into the proper functioning of financial markets, we have definitely moved away from free markets.

"At the end of this transition phase, the equilibria among risk premia will not be the same."

At the end of this transition phase, the equilibria among risk premia will not be the same. It is necessary for long-term investors to organise their portfolio construction according to such a horizon and prepare for it. It is necessary, above all, to learn from the lessons of the 1970s and reopen the textbooks to relearn what the risk premia could be in such an environment.

Changing economic lens in a regime shift

"On the road back to the 70s, investors should expect more 'heterodox economics' and changes in the relevance of key indicators of portfolio management."

On the road back to 1970s, powerful aspects of regime shifts will be unleashed, stemming from changes in what should be seen as "socio-political macro cycles". One aspect to this is that disparities in economic growth, risk premia and asset returns are likely to be explained by politics and policies (on top of the well-known technology changes, labour dynamics, etc.). At least, this was the thesis of the Nobel Prize winner Douglass North.

Building on his theory of institutions and distinguishing between political rules and economic rules, research has identified a political risk factor (*P-factor*) in developed and emerging countries with a convincing predictivity power on cross-sectional returns. More (less) political risk entails lower (higher) returns (Henry and Miller).

The P-factor is not spanned by prominent benchmarks and is priced into developed, emerging and frontier markets, with risk premium up to 15% per annum. This has profound implications on the asset allocation framework for investors in a period of regime shift.

On the road back to the 1970s, investors should also expect more "heterodox economics" and, above all, shifts and changes in the importance and the relevance of key indicators of portfolio management, such as interest rates, inflation, debt and currency. This will have to be taken into account in portfolio construction.

Table 1: Orthodox vs. Heterodox economics, and key variables to watch

Zeitgeist Orthodox economics	How the economy is managed	Modern monetary theory Heterodox economics
Monetary and fiscal policy both have a place, but monetary policy first	Dominant policy tool	**Fiscal policy** is the only effective tool
Interest rate is the key variable to achieve full employment and stable prices	Primary economic manager	**Jobs guarantee** to achieve full employment, taxes to restrain spending / inflation
See world through **macro aggregates**	Approach to economics	See world through **accounting identities**
Real and financial constrain matter	Macro constraints	**Only real constraints matter**, see through higher inflation
Must be financed and matter over the long term	Deficits	**Irrelevant** – shouldn't be part of the policy conversation
To finance government spending	Taxes	**To slow excess consumption and inflation** and ensure **demand for currency**
	Key economic variables	
Primary tool of macro management, deficits may push rates up	Interest rates	Minor tool, deficits push rates down, debt issuance purpose is to raise rates
Too high inflation would require an economic slowdown driven by higher rates	Inflation	Inflation would only require a slowdown, if driven by excess of demand, done through higher rates
Debt used to finance deficits	Debt	Debt used to raise rates, if needed
Largely exposed	Currency	Floating to ensure monetary sovereignty, taxes are what ensures demand for a flat currency

Source: Bernstein US Economic analysis.

Investment implications of different regimes

"Asset classes show different behaviours in different regimes, and consequently the role they may have in portfolio construction may change."

Asset classes show different behaviours in different regimes, and consequently the role they have in portfolio construction may change.
We have analysed the behaviour of different asset classes between 1960 and 2018, during different inflation regimes[1]. We have identified five inflation regimes: three normal and two hyperinflationary regimes (one in economic recovery and one in recession) that occurred in the 1970s.

Table 2: inflation regime features

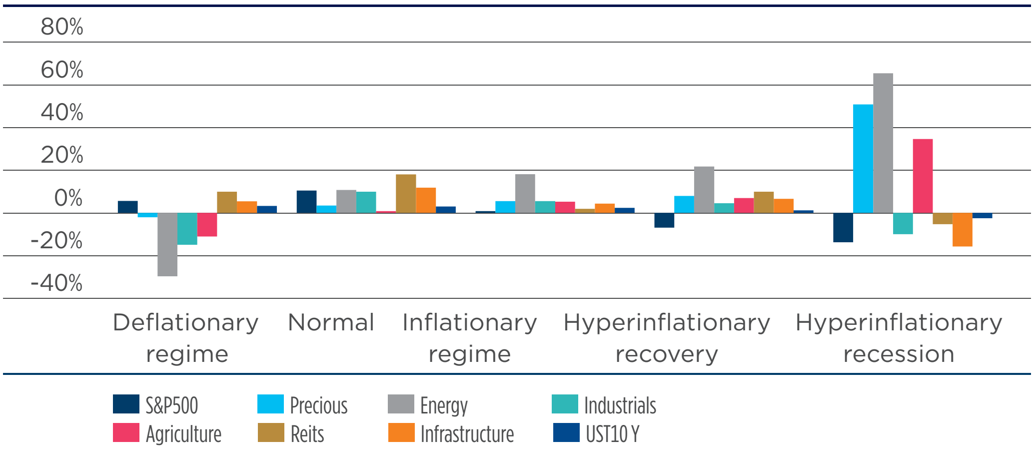
Regimes	CPI YoY (%)	PPI YoY (%)	PCE YoY (%)	Unit labour cost YoY (%)
Deflationary regime	<2	<1	<2	<1
Normal	2-3	2-3	2-3	2-3
Inflationary regime	3-6	3-6	3-6	3-6
Hyperinflationary recovery	6-10	6-10	6-8	6-9
Hyperinflationary recession	>10	>10	>8	>9

Source: Amundi Research, Lorenzo Portelli, Inflation Phazer proprietary model.

In the extraordinary hyperinflationary regimes in the 1970s, while growth (nominal and real) was not necessarily bad, production was less efficient than in the 1960s (declining EPS to sales ratio) due to wages pressures that pushed residential property prices higher. In line with academic literature, our model shows that equities have not delivered well (in nominal, real and risk-adjusted terms) and multiples have been depressed (PE and Shiller CAPE). Commodities, mainly precious metals, in a hyperinflationary recession and, to some extent, infrastructure in a hyperinflationary recovery phase, seem the most remunerative assets.

"A back-to-the-70s scenario is not expected to be benign for many asset classes. Should it materialise the picture would definitely be gloomier than the end of 60s."

Figure 8: Financial assets real returns in different inflation regimes



Source: Amundi Research. Data as of 24 April 2019. S&P500, US global REITS from global financial data; US T10yrs from Bloomberg; global infrastructure (equities), total returns series proxied by a basket of 50% utilities and 50% transportation; precious metal: GSCI Precious Metals Total Return Index, proxied by gold before index starts; Energy: GSCI Energy Total Return Index, proxied by Brent Crude Oil before index starts; Industrial metals: GSCI Industrial Metals Total Return Index, proxied by copper before index starts; Agriculture: GSCI Agriculture Total Return Index.

[1] To feed cluster analysis, regimes are identified by US CPI yoy change, US PPI yoy change, US PCE Core yoy change and US ULC.

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All in all, a back-to-the-70s scenario is not expected to be benign for many asset classes. Should it materialise the picture would definitely be gloomier than the end of the 1960s in terms of productivity and factors remuneration, due to so-called profits financialisation.

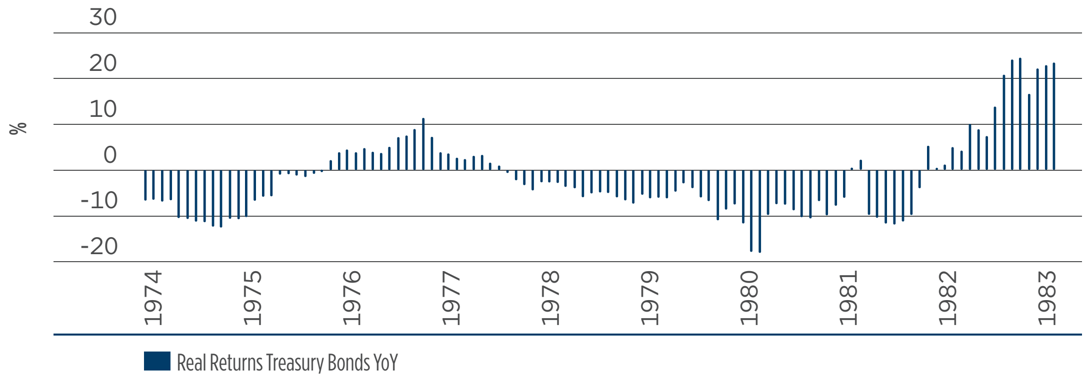
Asset class role in portfolio construction: in the 70s, bonds and equities as "substitutes"

"Over the Great Inflation period, bonds and equities both disappointed. Real assets, commodities and gold have done much better"

The Great Inflation of the 1970s began in late 1972 and did not end until the early 1980s, although inflation had been rising since the mid-60s. Jeremy Siegel, in his book *Stocks for the Long Run: A Guide for Long Term Growth* (1994) called this period, "the greatest failure of American macroeconomic policy in the post-war period".

The US equity market (S&P500 index) lost 43% in an 18-month period (from March 73 to September 74), making these among the worst performing years in the 20th century. Government bonds were vulnerable too, with negative performances in real terms in the period from 1977 to 1980 as interest rates skyrocketed from 7.4% to almost 16% in 1981.

Figure 9: Bond investors and the terrible 70s (US Treasury real returns, YoY, (%))



Source: Bloomberg, data as at 3 April 2019. Rolling one-year real returns calculated on the Bloomberg Barclays US Treasury Index excess return vs. CPI YoY growth.

By contrast, real assets, commodities and gold have done much better. Real estate in this phase benefitted from double support: stability in real yields and a reduction in the cost of the repayment of loans due to inflation (the real cost of debt).

Table 3: Asset class returns

1972-1981	Annualised nominal return %	Annualised real return %
House price	9.4	0.1
S&P 500 Index	5.2	-4.0
US Treasury index	5.5	-3.7
Gold price	22.5	13.3

Source: Amundi elaboration on Bloomberg data. Period 31 December 1972 to 31 December 1981. S&P 500 Index refers to the total return gross dividend index,. US Treasury index refers to ICE BofAML US Treasury & Agency Index, House price refers to the US Home Price from Shiller.

As documented in academic research on inflation and the price of real assets (Piazzesi and Schneider): "Negative co-movement of house and stock prices drove a 20% portfolio shift out of equity into real estate. The Great Inflation led to a portfolio shift by making housing more attractive than equity. We see three main reasons for that: 1. Agents interpret higher inflation expectations as bad news for future stock returns. 2. Uncertainty on the inflation path also weigh on the stock market, 3. Changes in inflation expectations make housing more attractive because of capital gains taxes on stocks vs mortgage deductibility. Taken together these effects can explain the opposite movements of house and stock prices in the 1970s."

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However, the social cost of higher inflation was very high: many people were priced out of new cars and homes by skyrocketing interest rates and the aggregate household net worth relative to GDP dropped by 25% in 1970s.

"During the 70s regime, inflation, inflation expectations and their volatility constituted a central theme. In this phase, equities and bonds were two asset classes that could be substituted."

During the 1970s regime, inflation, inflation expectations and their volatility constituted a central theme. In this phase, **equities and bonds were two asset classes that could be substituted and had comparable behaviour:** in leading stock returns and more generally asset price returns, the monetary component (with interest rates as the proxy) prevailed on the real component (with earnings as the proxy).

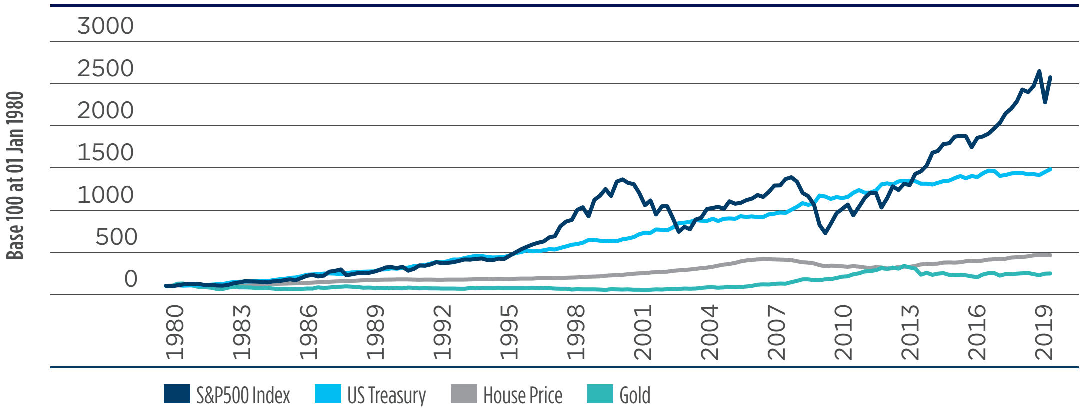
In other words, the "government bond" component tended to accentuate or accelerate the direction and the performance of the "risky asset" component, of which equities could be a proxy. **Such a portfolio was, in a nutshell, a mono-asset class** (since equities and bonds have similar behaviour and are driven by interest rates) and above all offered an arbitrage between equities and bonds, an arbitrage on the equity risk premium.

In periods of high inflation, the traditional diversification between equity and fixed income does not work, while real assets act as a hedge against inflation. In periods of significant disinflation, such as the 1990s, traditional diversification does not work either. Equities behave like bonds, as interest rates are the main driver. They are even better then bonds when interest rates decline on a trend basis, as evidenced by the strong negative correlation between bond yields and equity prices from the early 70s to the early 2000s, with interest rates leading by six months. It is therefore important to make a distinction between: 1) inflation/disinflation periods (1970s-80s); and 2) no inflation/deflationary tensions (1990s-today).

After the Great Inflation: equities and bonds as "complements"

The regime which followed the Great Inflation has been instead supportive for stock prices and the S&P500 trumped the real estate market.

Figure 10: The dominance of financial assets



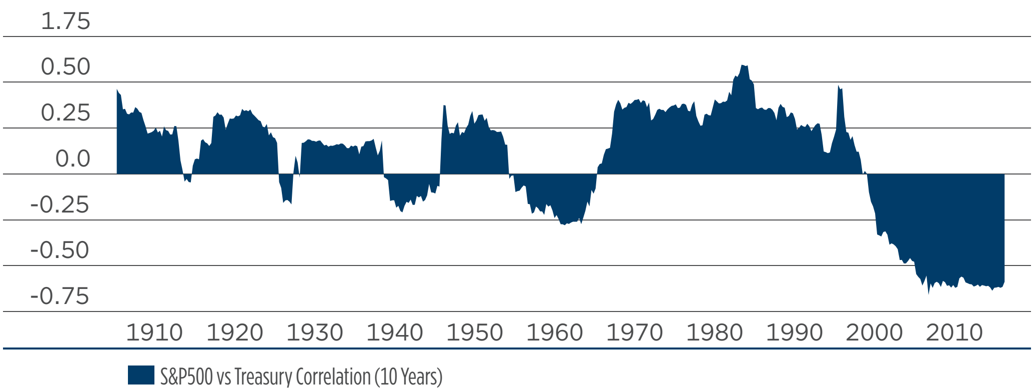
Source: Amundi elaboration on Bloomberg data, as of 24 April 2019. S&P500 Index price, US Treasury index refers to ICE BofAML US Treasury & Agency Index, House price refers to the US Home Price from Shiller and update from S&P Core Logic Case Shiller National Index.

"In a macro-financial regime of low and stable inflation and inflation expectations, the two asset classes, equities and bonds tend to be complementary".

In a macro-financial regime of low inflation (with even some deflationary pressure), low volatility of inflation or inflation expectations and subdued inflation expectations, the two asset classes equities and bonds tend to be complementary; bonds and equities tend to show a negative correlation as inflation is too low to represent the driving factor. This regime is the one that we have entered following the crisis.

It reminds us of the one of the 1960s, with weaker long-term growth trends and low inflation with low volatility: these are periods when earnings are the dominating components of returns. There is a diversifying effect between bonds and equities playing in the portfolio since the two asset classes are more negatively correlated (positive correlation between bond yields and equity prices). This means that bonds are seen as a cushion for protection for risky assets exposure, with obvious limits and challenges as evidenced in the euro debt crisis, when it became clear that not all government bonds are risk-free assets.

Figure 11: Bond and equity correlation



Source: Amundi elaboration on Global Financial Data. 10 years rolling correlation on quarterly data. Data as at end of 2018.

"A combination of real assets, inflation-linked securities and alpha strategies that can capture the risk premia evolution could help investors to protect their portfolios against an inflationary regime."

Conclusion

A new regime shift, in a road back to the 1970s, would have profound implications in setting strategic asset allocation and in portfolio construction, as the utility function of bonds and equities in reference portfolios changes significantly. In an inflationary regime, equities and bonds are interchangeable, interest rates remain the determining factor of returns and the diversification effect is weak. In a non-inflationary regime (and/or with deflationary tensions), equities and bonds are more complementary, with a diversification effect (decorrelation).

However, the bond component loses the protection/cushion component for exposure to risky assets when interest rates are very low, the risk-free status of these bonds has to be reconsidered and they should be considered more for liquidity purposes.
Therefore investors should consider different inflation regimes and their implications for asset classes in their portfolio construction.

Table 4: Investment strategies in different inflation regimes

	Back to the 70s		Today		
	Inflation (general and uncontrolled price increase)	**Disinflation (deceleration of price increase)**	**Low inflation (low and stable price increase)**	**Deflation (declining prices and declining activity)**	**Stagflation (low growth and high inflation)**
Cash	Buy	Sell	Sell	Massive buy	Sell
Bonds	Massive sell	Buy	Buy	Massive buy	Buy...to some extent
Equities	Massive sell	Massive buy	Buy	Buy...to some extent	Massive sell
Commodities	Massive buy	Sell	Neutral	Massive sell	Buy
Gold	Massive buy	Massive sell	Neutral	Buy	Massive buy
Real estate	Neutral	Buy	Buy	Massive sell	Sell

Source: Amundi Research, *Real assets: what contribution to asset allocation, especially in times of crisis?* Philippe, Ithurbide and Bellaiche, 2017.

A road to the 70s would require us to rethink or reinvent diversification. A combination of real assets, inflation-linked securities and alpha strategies that can capture the risk premia evolution could help investors to protect their portfolios against an inflationary regime.

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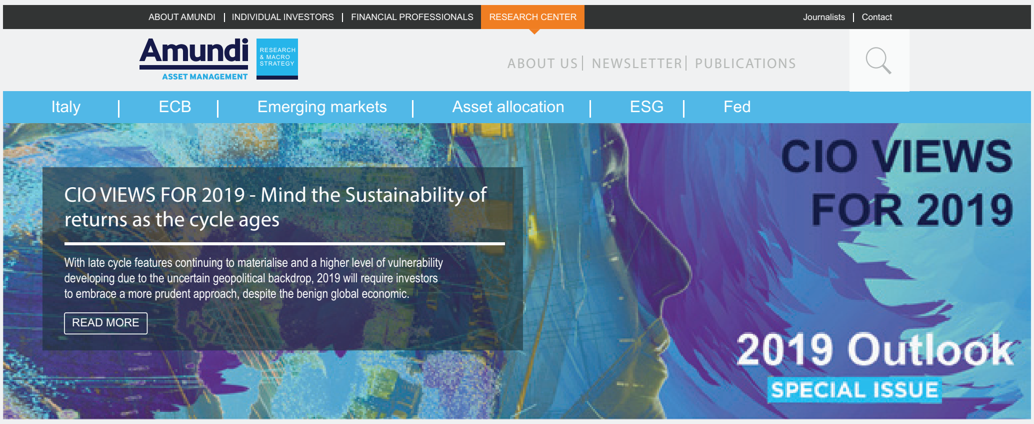

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Chief Editors

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