Inflation Update, October transcript

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Since our last media update, a lot has happened in the inflation-linked bonds market.

Volatility increased during the summer and there were significant fluctuations in inflation breakevens.

Let's break down this movement. In July and August, inflation expectations declined on the back of increasing recession fears. Brent oil plummeted over 20%
and went below the $70 per barrel mark.

The market even priced in a mere 1.7% total inflation for the US over the next 12 months. There were three primary factors that explain this move.

The first factor is the announcement from President Biden to retire from the presidential campaign in the US and the arrival of Harris as the Democrat nominee. This led to the unwind on the Trump trade.

A shift in sentiment from a robust economy to increasing recession fears, not only because China data disappointed, but also because there were less strong hard data and leading indicators in Western economies.

The third factor is attributed to lower inflation pressures because data in the labour market showed some signs of cooling. After the fall in inflation expectations, September brought some relief to the asset class. This was not only due to what we considered to be extreme low levels of valuation, but also to their recovery in oil prices and recently to upwards surprises in economic data.

Breakevens have been increasing and start to approach levels that are much more consistent with central bank's targets. As inflation pursues its normalisation process, central banks are more comfortable to reduce the aggressiveness of monetary policy.
Our strongest conviction goes to long duration positions as rates should continue the downward path benefiting fixed income assets.

However, when we add duration to portfolios, we prefer inflation-linked bonds, namely real rate rather than nominal rates.
There are three key reasons for this preference. The first one: data dependency.
The second one: attractive levels of valuation. And the third one: the balance of risk.

Let's deep dive into these three reasons. The first one, data dependency:

Central banks have signaled how data dependent they are, and even though they will not be paying a lot of attention to a single data point, a change of a trend in inflation could stop them in their cutting cycle.

In such a scenario, inflation-linked bonds should outperform nominal bonds. The second reason is attractive levels of valuation. On one hand, real rates do not yet reflect the evolution of monetary policy that has been integrated into nominal rates. On the other hand, real rates remain at historical high levels, offering an attractive premium to investors looking to hedge their inflation risk.
The third reason is the balance of risk. While we expect inflation to reach
a 2% target next year or in 2026 at latest, we still see the balance of risk tilted to the upside.

For the next three months, the key risk to highlight is the US presidential elections, for which the polls remain quite tight, with a 50% probability of Trump taking office again. If this were to be the outcome, then inflation would probably be higher than what is currently priced by the market.

These inflationary pressures may come from looser fiscal policies, namely tax cuts, tariffs to imports and anti-immigration policies.

There are no clear signs that we are entering a recession, but economic data suggest that we are facing late cycle dynamics, including inflation-linked bonds
in a portfolio may allow an investor to benefit from lower rates, while also hedging higher inflation risk.

Source: AXA IM as of October 2024

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