Are markets proving complacent on inflation?

3 March 2024

Dear Clients and Partners,

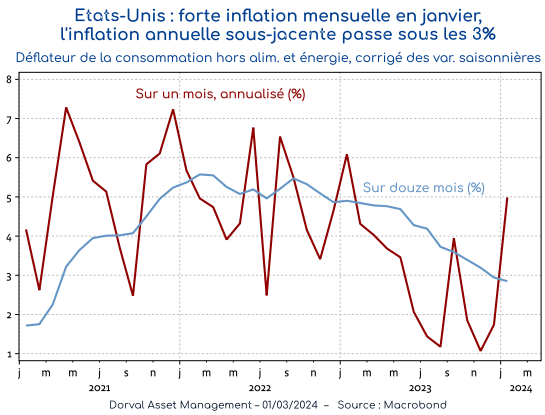
Equity markets remain strong, in spite of poor recent inflation figures in the United States and Europe. Could this be a sign of complacency?

The S&P 500, Nikkei and MSCI World indices, along with the majority of the most-followed equity market indices, have all hit new historic highs in recent days. Even when adjusted for the effects of the AI boom on the price of some of the largest listed equities, markets have grown significantly. Take, for example, the MSCI World Equal Weighted Index, which reached its highest level since the war in Ukraine first broke out. Conversely, the latest news on inflation has been disappointing on both sides of the Atlantic. Are equity markets getting carried away, ignoring the risks of persistent inflation?

Let us first consider the numbers. In the United States, the consumption deflator – the Federal Reserve's preferred indicator – saw a strong resurgence in January, rising by +0.4% over the month (or 5% in annualised rate), excluding food and energy (cf. chart 1). This is the highest figure in a year. Conversely, core inflation has continued to subside over the past 12 months to hit +2.8% year-on-year, its lowest level since March 2021. With inflation highly volatile from month to month, it is possible that the poor figure for January 2024 is partly due to seasonal effects that have not been properly accounted for by statistical offices. Some doubt therefore remains as to this figure's significance, and there is little risk that Fed members will amend their rate cut expectations based on a single month.

United States: strong monthly inflation in January, core annual inflation dips below 3%

Consumption deflator excluding food and energy, seasonally adjusted

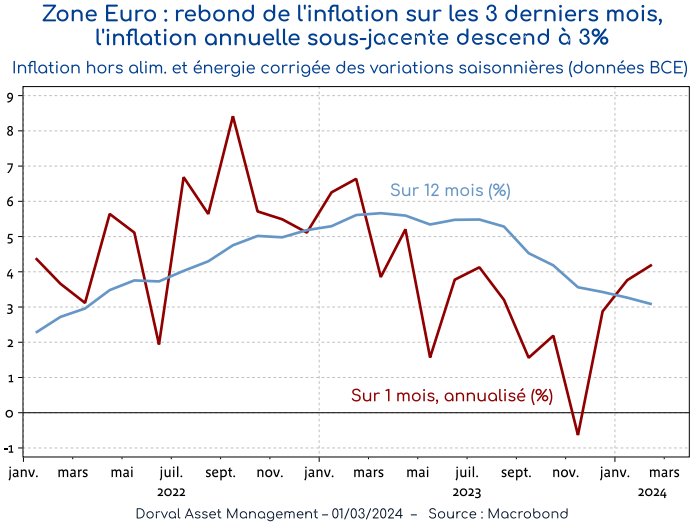


- *Over 1 month annualised (%) / Over 12 months (%)*

It's a different story in the eurozone, where the inflation figures for February have been disappointing for the third consecutive month and core inflation has ramped back up quite sharply (cf. chart 2). That being said, these figures are not quite as bad as the figures from this time last year, allowing annual inflation to keep declining gradually to reach 3% (excluding food and energy). For the ECB, all of these figures mean that the earliest possible date for a rate cut would be June – not April – and the market has now taken note.

Eurozone: resurgence in inflation over the past three months, with core annual inflation falling to 3%

Inflation excluding food and energy, seasonally adjusted (ECB data)

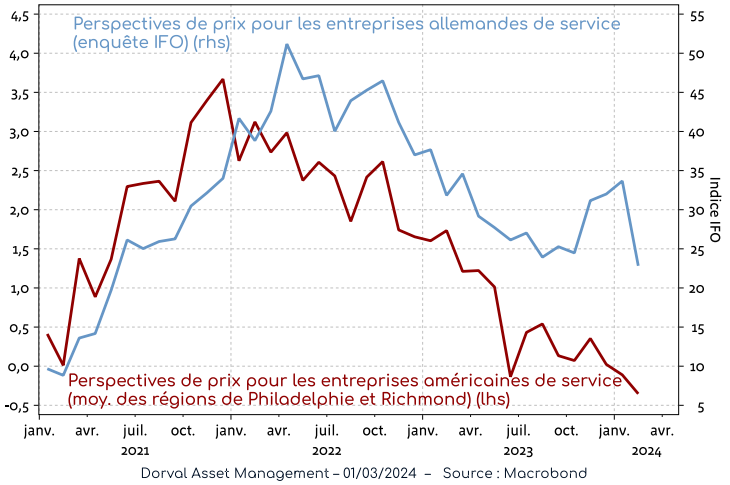


- *Over 12 months (%) / Over 1 month annualised (%)*

In the coming months, we can expect sequential inflation in the eurozone to subside for several reasons. Lower wholesale electricity prices and a sharp deceleration in food prices are expected to have favourable second-round effects on core inflation. Furthermore, wage growth has begun to slow in some countries, including France and Spain, and the ECB's research in this area suggests that it reached its peak at the end of 2023 across the eurozone as a whole. Finally, surveys of companies suggest that pressure on prices in the service sector, which saw an upswing at the turn of the year – especially in Germany – is now declining sharply (cf. chart 3). This easing mirrors a trend also seen in the United States. Unless commodity prices rise sharply and rapidly, outlooks on inflation should remain relatively favourable – especially since the eurozone has yet to emerge from the economic stagnation in which it has been mired since autumn 2022.

Surveys of companies in the service sector do not lend credence to a potential resurgence in inflation

Les enquêtes auprès des entreprises de services ne valident pas l'hypothèse d'une remontée de l'inflation



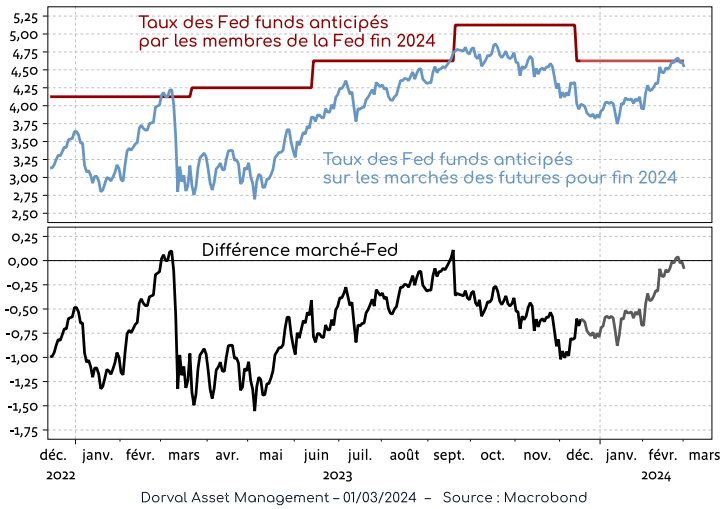
Dorval Asset Management – 01/03/2024 – Source : Macrobond

- *Price outlook for German companies in the service sector (ifo survey) (rhs) / Price outlook for US companies in the service sector (average for the Philadelphia and Richmond regions) (lhs)*

Financial markets therefore have a few reasons not to panic over the recent bad inflation figures. However, expectations of rate cuts have been corrected and now align with central banks' prevailing scenario, which should limit future risks for bond markets. As such, the short end of the US rate curve includes a drop in rates of 75 basis points by the end of the year, in line with the scenario supplied by Fed members this past December (cf. chart 4).

Markets aligned with the Fed

Les marchés en ligne avec la Fed



Dorval Asset Management – 01/03/2024 – Source : Macrobond

- *Fed funds rate anticipated by Fed members for the end of 2024 / Fed funds rate anticipated on the futures markets for the end of 2024*
- *Difference in market and Fed rate anticipations*

As for the equity market, it has become somewhat disconnected from bond markets – and for good reason, in our view. Sitting at around 3%, and even slightly lower in the US, annual core inflation is now low enough for central banks to act quickly should there be a significant weakening in growth forecasts. According to our scenario, it is such a put by central banks that is behind this resurgence in optimism among equity investors. At this stage, this sentiment still seems justified to us – although we will of course be keeping a weather eye on the trajectory of inflation in the coming months.

In the short term, our view is therefore that a more likely risk for equity markets lies in overbought market indicators, which are fairly high, rather than in inflation. In our European flexible funds, we have been implementing an options strategy on the EURO STOXX 50 index for several weeks that will gradually limit the rate of exposure to the market as it rises.

Our exposure rates are as follows:

- **Dorval Convictions:** The equity exposure rate is 65%.

Dorval Asset Management

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Paris Trade and Companies Register No. B 391392768 – APE 6630 Z –
AMF accreditation no. GP 93-08

1 rue de Gramont, 75002, Paris – T: +33 1 44 69 90 44 – F: +33 1 42 94 18 37

www.dorval-am.com

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