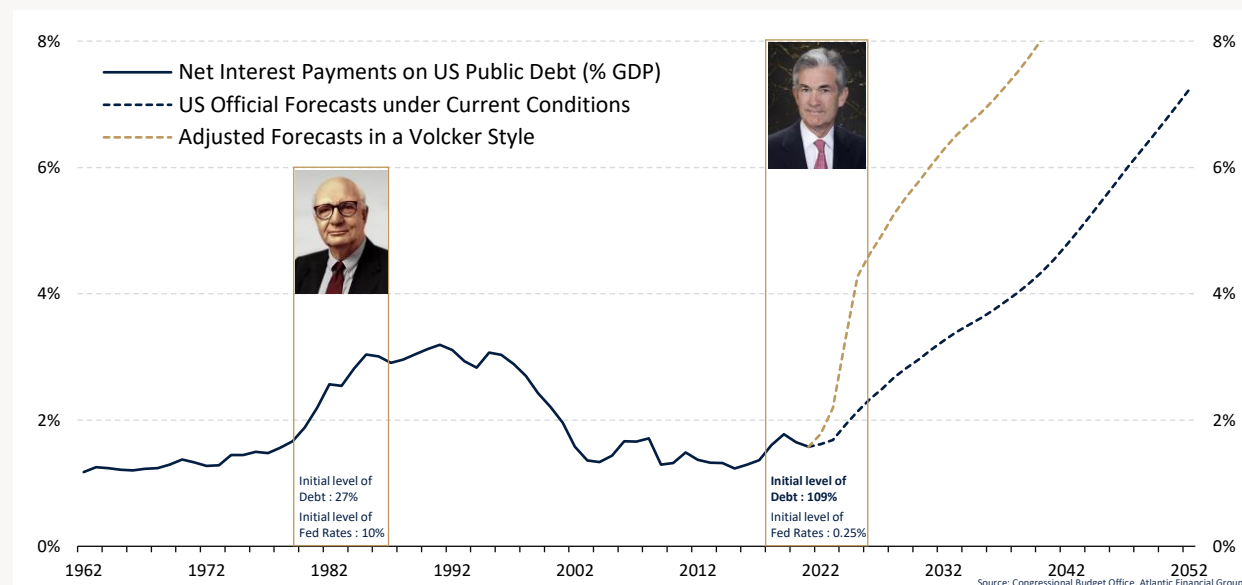




"JEROME POWELL WILL NEVER BE PAUL VOLCKER"

- ◆ The recessionary impact of inflation is underestimated, even by central bankers
- ◆ By tightening their monetary policy, they are trying to apply the Volcker method
- ◆ But, unlike the 1980s, the debt is so high that they will have to give up
- ◆ A significant rise in interest rates would make the debt burden unsustainable

CHART OF THE WEEK: "The debt is too high for J. Powell to imitate P. Volcker"



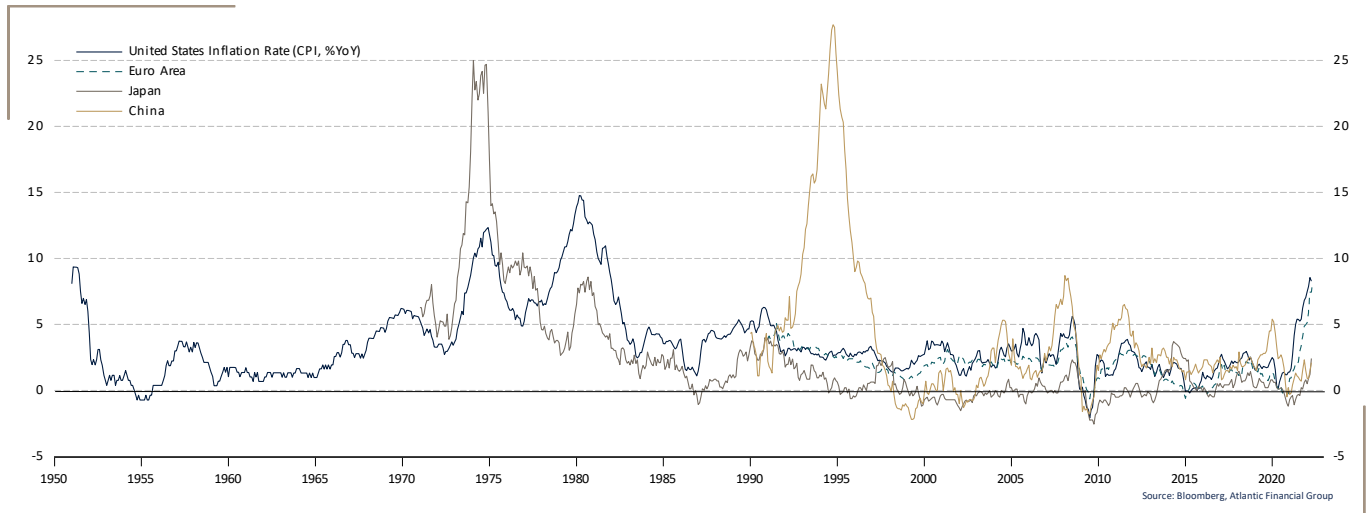
BOND MARKET ANALYSIS

Inflation will have been consistently higher than expected over the past two years. We have not been more forward-looking than the consensus of economists, consistently underestimating the surge in prices. Even today, inflation continues to surprise on the upside, in different countries and sectors. **It is close to its highest level in the last 40 years** (see Fig. 2). In the US, consumer prices rose by 8.5% year-on-year in March. In the Euro Area, the harmonised price index, which serves as a reference, rose by 8.1% in May. In Switzerland, where prices have stagnated since 2008, annual inflation has just been published at 2.9%.



Even Japan, which has been battling deflation for 35 years, has managed to import enough inflation that it finally seems to be making a comeback, at 2.5%.

Fig. 2 - Inflation in the world since 1950



All these figures shatter the 2% inflation target that central banks usually set for the medium term. Since their mandate is precisely to ensure price stability, they are obliged to act. In such a situation, **they have no choice but to raise their key interest rates or to promise to do so very soon.** By acting in this way, they seek to increase the cost of credit, slow down economic activity, reduce domestic demand and, ultimately, allow a new, lower price equilibrium to be achieved in the face of a supposedly constant supply.

The first problem comes from this last assumption. Supply is not constant, on the contrary. Raw materials, intermediate goods and some services are produced and offered in limited quantities, because of the lockdown measures implemented to tackle the Covid-19 pandemic, but also because of the Russian invasion of Ukraine. This complex geopolitical situation led to an embargo on products from Russia and a massive cutback in Ukrainian production. Finally, we must add to this the climatic disruption which prevents certain productions, particularly cereals. The supply of goods and services is therefore not constant. Raising key rates will not change anything. **Inflation is not "demand-pull" but "cost-push". It will persist even by dampening demand.**

In the coming months, inflation could continue to surprise and remain high, for the same reasons as mentioned above. Energy and agricultural commodity prices are at the heart of the problem (see Fig. 3), impacting on transport costs and foodstuffs, and ultimately on the services sector. **By contrast, inflation could also eventually subside because, by definition, inflation is a change in prices.** It is a flow and not a stock. It would be enough for the prices of certain goods to stabilise for inflation to tend towards zero, or for them to return to their pre-crisis level for inflation to become negative. In the US, for example, after two major peaks in the spring of 2021 and the winter of 2022, the price of lumber is in free fall. Inflation on this building material is now -54% (see Fig. 4).



Fig. 3 - Energy and food prices in Europe

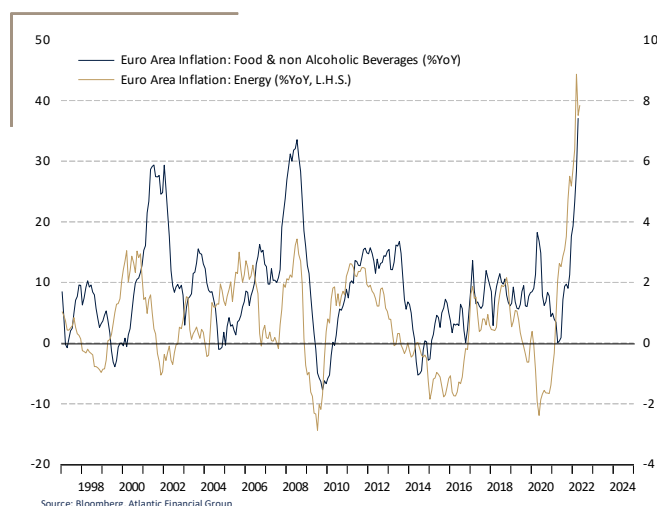
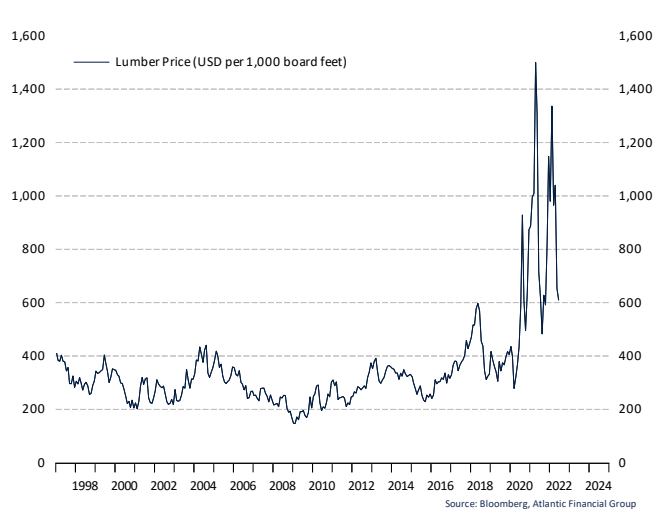


Fig. 4 - Lumber prices in the US



Our scenario is that the US inflation rate will reach 8% per annum in 2022, then stabilise with volatility due to base effects: 5% in 2023, 0% in 2024, 4% in 2025, 3% in 2026, 2% in 2027.

Forecasting inflation is one thing, but estimating its impact is another, much more important. Today, there are four phenomena that need to be considered by investors:

- 1. Inflation has been with us long enough for it to have a significant effect on the behaviour of governments, businesses, and households.** In the US, Joe Biden has declared inflation his top priority. To tackle soaring prices, he mentioned a measure that was unimaginable until recently: the lifting of tariffs on Chinese products, initiated by Donald Trump at the heart of the trade war between the two giants. In France, to limit the recessionary impact of soaring energy prices, the government has opted to artificially reduce the price of a litre of fuel by 18 cents. The state will go into debt to finance this aid.

For their part, companies are innovating to produce more cheaply but also to pass on the inflation in raw materials to the prices paid by the final consumers. They are redoubling their inventiveness. In Japan, for example, to avoid scaring shoppers, brands use the "shrinkflation" technique: they do not touch prices but reduce the size of their products. Some milk packs, washing powder cans and crisp packets have been reduced in weight by 10%.

Finally, the least wealthy households are making trade-offs between their spending. As evidence of this, their purchases are regularly below economists' and analysts' expectations. In the first quarter, Walmart and Target, the two giant US supermarkets and discounters, announced disappointing results. They said that households had to forego some of their purchases. Lacking pricing power, the retailers had no choice but to absorb some of the rising costs and ultimately squeeze their margins and profits.

- 2. It is not so much inflation that matters, but the perception of inflation** (see Fig. 5). The former impacts on purchasing power, the latter on purchasing behaviour. Europeans experienced this phenomenon in 2002 when the euro was introduced in place of the historical national currencies. At that time, inflation was around 2% but the perception of inflation was 6% (see Fig. 6). The increase in



prices of everyday consumer goods such as milk, coffee, bread or oil had been very strong, while the price of computers or cars tended to stagnate. Thus, even though households retained excellent purchasing power, their perception was that they were getting poorer. They therefore slowed down their consumption. **Today, even if prices were to stabilise and inflation were to move towards zero, there is a real risk that household spending will not rebound as it should.** The trauma of inflation will take time to dissipate.

Fig. 5 - Price expectations in Europe

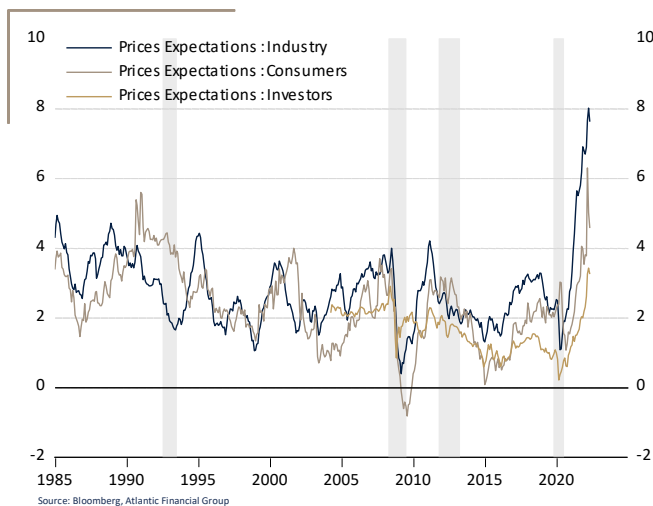
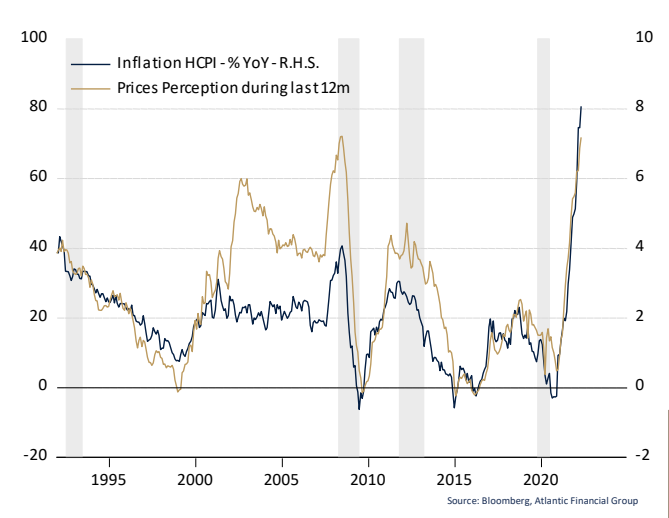


Fig. 6 - Inflation vs. price perception in Europe



3. **The recessionary impact of inflation is underestimated because it has not been experienced since the mid-1980s.** Most investors have forgotten or have not experienced the reaction of economic agents during these price booms. Moreover, in the previous oil shocks of 1973 and 1979, it was mainly companies that bore the brunt of inflation by increasing wages. In 2022, it will certainly be households that will suffer the effects. The labour market may be in a positive dynamic, but it is not strong enough to ensure that wage demands are met. **Wages will not rise as fast as prices, thus reducing the purchasing power of consumers. This is good news for business.**
4. **Central bankers are over-reacting to the inflation figures.** On the one hand, they feel that they are behind the curve, lagging in their hiking process. On the other hand, they hope to repeat the disinflationary success of the 1980s. **Jerome Powell has professed great admiration for Paul Volcker, whom he considers a model to follow. However, in wanting to act like his predecessor, the Chairman of the Federal Reserve (Fed) is mistaken.** The situation is not comparable. At the end of the 30 glorious years, the economic dynamic was very powerful: 4.5% real annual growth compared to 2.2% today. The challenge was not to sustain growth but simply to fight against pernicious inflation. Under Paul Volcker, monetary policy was simple and brutal: it started and ended with interest rates, no matter the economic cost.

Since the Great Financial Crisis of 2008 and the impetus of Ben Bernanke, the Fed has been using a much broader arsenal of tools: quantitative easing, lending facilities, forward guidance depending on economic variables. This "modern" application of monetary theory has allowed governments,



companies and households to take on more debt than ever before in peace time (see Figs. 7 & 8). Unlike in Paul Volcker's decade, growth dynamics are very weak and debt ratios are very high today. We have regularly detailed that central banks have lost their independence and cannot sustainably raise rates. The day will come when they will be forced to do a Yield Curve Control (YCC) by buying bonds, otherwise the interest burden on governments, companies and households will be such that too many of them will go bankrupt.

Fig. 7 - Private & public debt in the US

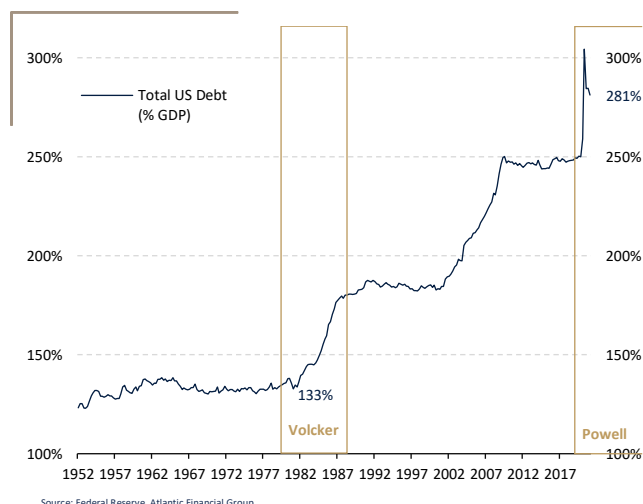
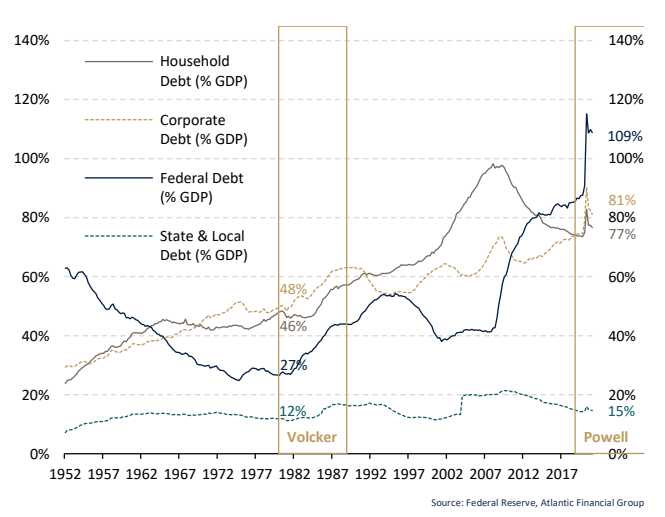


Fig. 8 - Debt decomposition in the US



Let us take a few concrete examples. Under Chairman Paul Volcker, the Fed raised rates from 10.5% in July 1979 to 19.1% in June 1981. As a result, the double-digit inflation fever finally came to an end. At the time, the government was in debt to the tune of 27% of GDP. Its interest burden had risen from 1.6% to 3% of GDP (see Chart of the Week). Today, with a debt level of 109%, if key interest rates were to rise just as sharply, the interest burden would rise from 1.6% to 5% and then 8% of GDP. Is it reasonable to think that the US government uses a quarter of its public revenue just to finance the interest on its debt? The same applies to companies, some of which are over-indebted, known as "zombies". The same reasoning applies to households, whose housing costs are only sustainable with relatively low mortgage rates. The recent rise in the 30-year mortgage rate from 3.2% to 5.5% in five months is already raising questions.

Finally, it should be noted that the example of the United States can be applied to the other major developed countries. **By fighting inflation excessively, central bankers are generating an extraordinary crisis.**

In the bond markets, in recent quarters, investors have taken note of relatively robust economic growth, structurally high inflation and tighter monetary policy. This scenario has led to rising bond yields (see Fig. 9) and a flattening of the curve (see Fig. 10). Today, much of this news is embedded in the bond markets. On the opposite, **if any of these three parameters were to change, be it for a recession, a decline in**



inflation or an easing of monetary policy, then sovereign bond yields would fall. In the third case, the yield curve could even steepen faster than expected.

Fig. 9 - US 10-year sovereign bonds

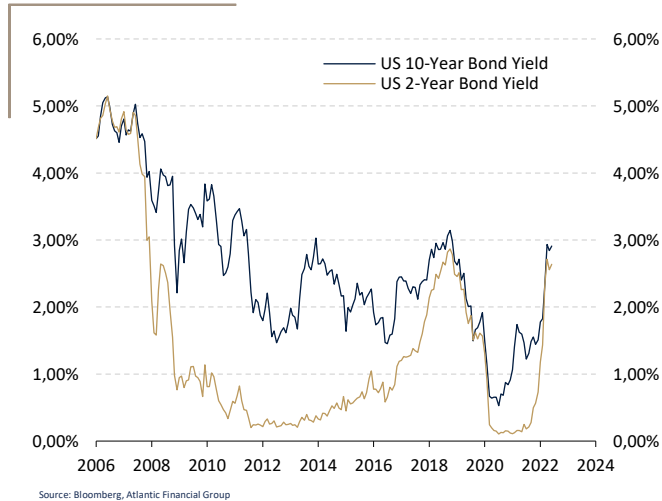
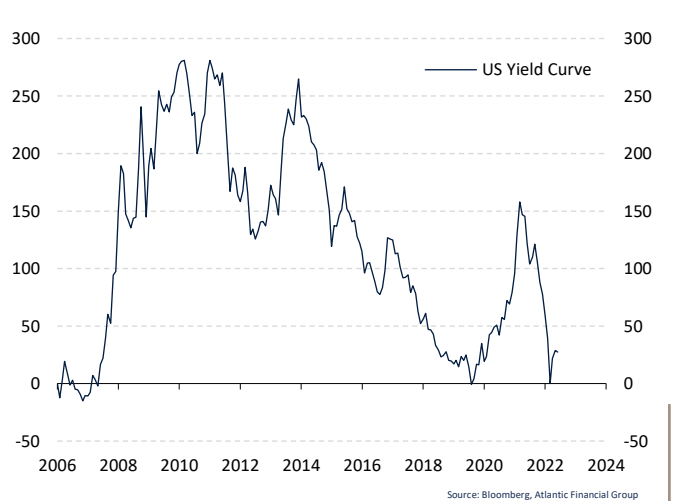


Fig. 10 - USD yield curve



Conclusion:

Inflation is higher than expected. Whether it is here to stay or not, companies and households have a very strong perception of it, which is changing their sales strategies for some and their purchasing behaviour for others. By acting actively to tackle this rise in prices, in the manner of Paul Volcker in the 1980s, central bankers are making a threefold mistake. They have very little effect on the general price level because it is linked to a supply shock. They push the economy into recession more than they imagine. They bring the problem of over-indebtedness back to the forefront. This environment is favourable for sovereign bonds.



RETURN ON FINANCIAL ASSETS

Markets Performances (local currencies)	Last Price	Momentum Indicator (RSI)	1-Week (%)	1-Month (%)	2022 Year-to-Date (%)	2021 (%)	2020 (%)
Equities							
World (MSCI)	649.2	51.01	-0.5%	-0.7%	13.1%	19.0%	16.9%
USA (S&P 500)	4 109	50.14	-1.2%	-1.4%	13.2%	28.7%	18.4%
USA (Dow Jones)	32 900	51.38	-0.8%	-0.3%	-8.6%	20.9%	9.7%
USA (Nasdaq)	12 013	48.83	-1.0%	-4.2%	22.9%	22.2%	45.0%
Euro Area (DJ EuroStoxx)	421.7	52.62	-0.7%	1.2%	-9.7%	23.5%	0.8%
UK (FTSE 100)	7 533	52.92	0.3%	0.3%	8.9%	18.4%	-11.4%
Switzerland (SMI)	11 529	43.63	-0.9%	-3.7%	-8.0%	23.7%	4.3%
Japan (Nikkei)	27 957	62.12	1.7%	3.5%	-2.6%	6.7%	18.3%
Emerging (MSCI)	1 061	53.74	1.8%	-0.4%	13.1%	-2.3%	18.8%
Brasil (IBOVESPA)	111 102	53.69	-0.7%	4.3%	6.0%	-11.9%	2.9%
Russia (MOEX)	2 308	41.70	-4.1%	-5.4%	-38.6%	21.9%	14.8%
India (SENSEX)	55 439	54.05	1.8%	-1.7%	-3.6%	23.2%	17.2%
China (CSI)	4 157	55.51	1.6%	2.1%	16.9%	-3.5%	29.9%
Communication Serv. (MSCI World)	86.10	48.44	-0.1%	-1.8%	21.5%	10.9%	24.2%
Consumer Discret. (MSCI World)	310.9	50.84	1.0%	-3.7%	23.8%	9.2%	37.0%
Consumer Staples (MSCI World)	266.7	44.97	-0.8%	-3.1%	-7.5%	11.7%	8.8%
Energy (MSCI World)	253.2	67.53	1.2%	11.1%	37.0%	37.5%	-27.7%
Financials (MSCI World)	136.6	51.09	-1.1%	0.4%	-7.7%	25.1%	-3.1%
Health Care (MSCI World)	332.2	45.42	-2.5%	-0.6%	-9.2%	18.0%	15.4%
Industrials (MSCI World)	285.2	54.23	0.6%	0.7%	13.2%	16.6%	11.8%
Info. Tech. (MSCI World)	446.4	50.22	-0.7%	-2.7%	22.0%	27.6%	46.2%
Materials (MSCI World)	349.8	55.58	0.4%	1.2%	-2.4%	15.4%	21.6%
Real Estate (MSCI World)	201.8	46.24	-1.5%	-3.4%	13.1%	23.6%	-5.7%
Utilities (MSCI World)	161.6	52.73	-1.3%	3.2%	0.8%	11.1%	4.8%
Bonds (FTSE)							
USA (7-10 Yr)	2.95%	42.44	-1.4%	-0.2%	10.1%	-2.4%	9.3%
Euro Area (7-10 Yr)	1.85%	34.50	-1.7%	-1.9%	11.2%	-2.9%	4.5%
Germany (7-10 Yr)	1.27%	32.43	-1.8%	-2.1%	-9.9%	-2.7%	3.0%
UK (7-10 Yr)	2.16%	37.08	-1.6%	-1.2%	-7.7%	-4.9%	5.4%
Switzerland (7-10 Yr)	1.04%	36.26	-1.5%	-0.6%	-8.3%	-2.3%	0.4%
Japan (5-10 Yr)	0.24%	55.68	0.0%	0.2%	-1.0%	0.0%	-0.1%
Emerging (5-10 Yr)	6.98%	51.47	-0.6%	1.5%	15.1%	-2.3%	5.2%
USA (IG Corp.)	4.31%	49.45	-0.8%	1.9%	12.3%	-1.0%	9.9%
Euro Area (IG Corp.)	2.47%	30.55	-0.5%	-1.4%	-8.9%	-1.0%	2.8%
Emerging (IG Corp.)	6.71%	45.91	-0.2%	0.3%	13.2%	-3.0%	8.1%
USA (HY Corp.)	7.21%	56.55	-0.3%	1.0%	-8.4%	5.3%	7.1%
Euro Area (HY Corp.)	5.74%	43.25	0.5%	-1.1%	-8.2%	3.4%	2.3%
Emerging (HY Corp.)	9.71%	48.43	-0.4%	0.1%	11.3%	-3.2%	4.3%
World (Convertibles)	373.3	49.29	-0.1%	-2.6%	14.8%	2.4%	38.8%
USA (Convertibles)	497.0	49.49	0.1%	-3.4%	16.2%	3.1%	54.5%
Euro Area (Convertibles)	3 593	36.67	-0.7%	-3.4%	12.5%	-0.3%	6.1%
Switzerland (Convertibles)	176.0	29.03	-0.7%	-0.8%	-5.3%	-0.5%	0.5%
Japan (Convertibles)	197.5	58.34	0.5%	0.4%	-1.6%	3.3%	2.8%
Hedge Funds (Crédit Suisse)							
Hedge Funds Indus.	745.0	75.12	n.a.	0.4%	n.a.	8.2%	6.4%
Distressed	965.8	51.89	n.a.	0.1%	n.a.	12.5%	3.8%
Event Driven	788.1	55.86	n.a.	-0.8%	n.a.	12.9%	7.0%
Fixed Income	387.6	64.24	n.a.	-0.5%	n.a.	5.2%	3.6%
Global Macro	1 443	82.20	n.a.	3.1%	n.a.	9.6%	6.5%
Long/Short	880.0	55.07	n.a.	-1.3%	n.a.	8.3%	7.9%
CTA's	400.8	80.39	n.a.	4.4%	n.a.	8.2%	1.9%
Market Neutral	287.2	61.49	n.a.	-0.9%	n.a.	6.2%	1.7%
Multi-Strategy	727.7	77.52	n.a.	1.3%	n.a.	7.0%	5.6%
Volatility							
VIX	24.79	42.72	-3.6%	-15.2%	44.0%	-24.3%	65.1%
VSTOXX	23.39	37.94	-1.9%	-25.5%	21.4%	-17.6%	67.5%
Commodities							
Commodities (CRB)	629.1	n.a.	-0.1%	-1.8%	8.8%	30.3%	10.5%
Gold (Troy Ounce)	1 856	48.27	0.0%	-1.5%	1.5%	-3.6%	25.1%
Oil (WTI, Barrel)	118.87	65.68	3.3%	16.1%	54.4%	58.7%	-20.5%
Oil (Brent, Barrel)	124.10	66.96	4.8%	17.1%	60.7%	51.4%	-23.0%
Currencies (vs USD)							
USD (Dollar Index)	102.02	47.71	0.3%	-1.6%	6.6%	6.4%	-6.7%
EUR	1.0733	54.27	-0.4%	1.7%	-5.6%	-7.5%	9.7%
JPY	130.71	35.60	-2.4%	-0.1%	12.0%	-10.2%	5.1%
GBP	1.2503	46.66	-1.2%	1.3%	-7.6%	-1.0%	3.1%
AUD	0.7203	55.23	0.1%	1.8%	-0.8%	-5.6%	9.6%
CAD	1.2577	63.55	0.6%	2.4%	0.5%	0.7%	2.1%
CHF	0.9620	54.64	-0.5%	2.8%	-5.1%	-3.0%	9.4%
CNY	6.6511	48.93	0.2%	0.2%	-4.4%	2.7%	6.7%
MXN	19.516	66.17	0.1%	3.1%	5.2%	-3.0%	-5.0%
EM (Emerging Index)	1 699.1	54.93	0.3%	0.4%	-2.0%	0.9%	3.3%

Source: Bloomberg, Atlantic Financial Group

Total Return by asset class (Negative \ Positive Performance)



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