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US consumer prices exceed expectations

May 2021

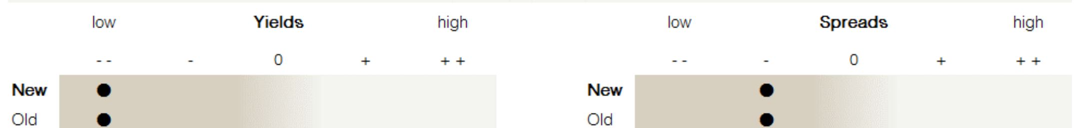
- Transitory inflation pressure
- Disappointing labor market data out of the US
- Fading stimulus payments likely to dampen excess demand
- Risk premium for equities rises slightly

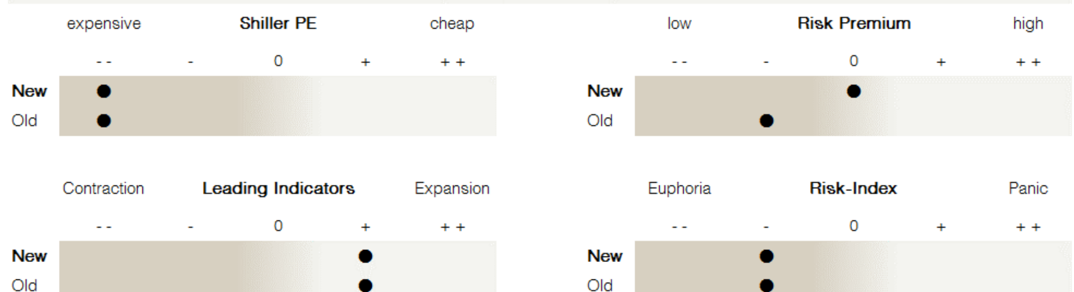
Inflation or even stagflation?

US consumer prices rose far more than expected in April. Prices climbed by 4.2% year-on-year, while the average economist polled by Reuters expected an increase of 3.6%. This means that the change in prices moved far above the 2% threshold that is considered desirable by the Federal Reserve. At 3%, the core inflation rate, which is adjusted for the particularly volatile energy and food prices, reached the highest level in 25 years. However, part of the sharp increase is certainly attributable to a base effect. The particularly "hard" pandemic months of April and May 2020 lead to a considerable distortion in trend inflation rate, which will also be noticeable next month. Nevertheless, the increase in prices remains substantial even taking the latter effect into account. Therefore, it is worthwhile to investigate whether a structural increase in inflation is likely.

So far capital markets hardly reacted to the latest inflation scare. The yield on 10-year government bonds rose slightly to 1.62% from 1.60% after the price data was released. Derivative markets, namely the inflation swap, which is an important measure for inflation expectations, rose only marginally. It looks like markets already anticipated higher inflation which was visible when looking at the strong rise of 10-year government bond yields over the past few months.

In our opinion, there are good reasons for the calm reaction in fixed income markets. A large number of companies assumed that the recession would last much longer and sharply curtailed their inventories. Today, this leads to temporary price pressure, which should ease again once the resulting production bottlenecks have been resolved. Wage pressure should fade significantly once generous stimulus payments expire in the fourth quarter. Joining the labor market should then become worthwhile again in the lower wage brackets. On the demand side, a normalization is realistic, as high-income households start saving due to a potential tax rate hike. Furthermore, the excess demand from lower income brackets fueled by stimulus payments has probably peaked. Given these reasons, we assume that the economy is dealing with temporary price pressure and not with a structural and dynamic price development.





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While bond markets remain calm, we are noticing increased volatility in the stock market. This is likely caused by recently published US labor market data. While March numbers were already revised sharply lower, April data disappointed even more. Significantly lower-than-expected new job creation (266,000 vs. estimates of +1 million) was as underwhelming as unemployment figures (6.1% vs. 5.8% expected).

The combination of rising inflation and high unemployment is fueling fears of so-called stagflation, which we assign a low probability due to high productivity of U.S. companies and large infrastructure spending programs in the pipeline.

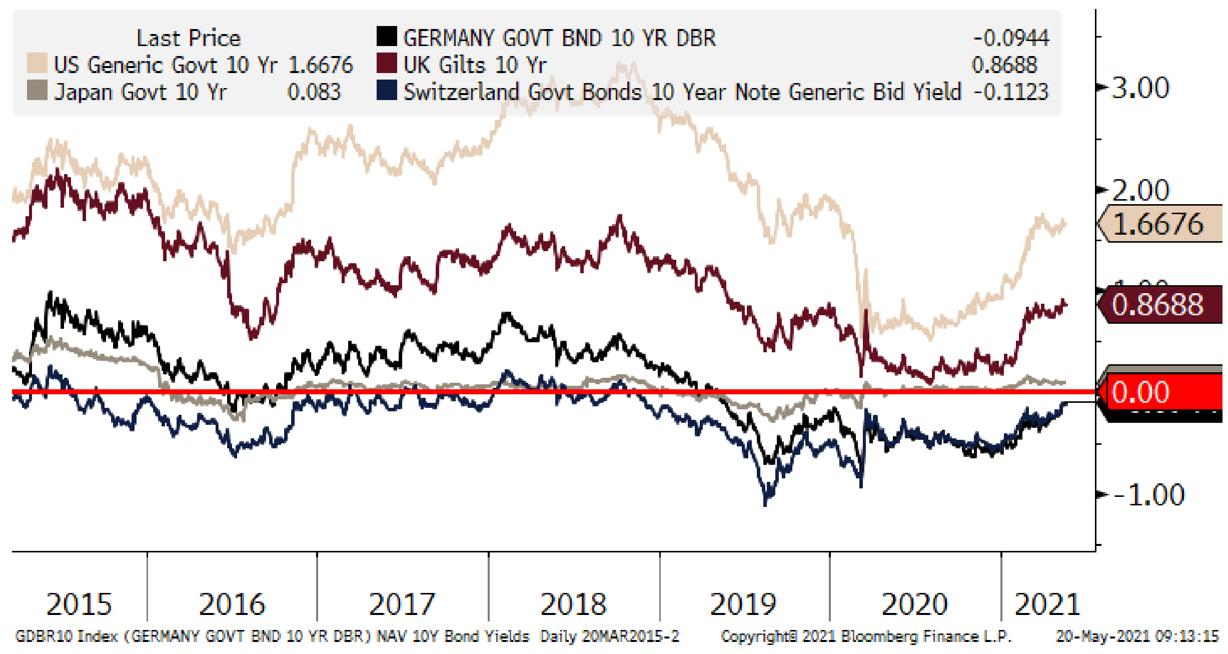
In all likelihood, we would use a correction of equity markets to increase our (still underweighted) equity allocation to a neutral level, provided our indicators give the corresponding signal.

We have made no changes to the investment categories since our last report. In terms of asset classes, lower real interest rates are leading to a more positive assessment of gold.

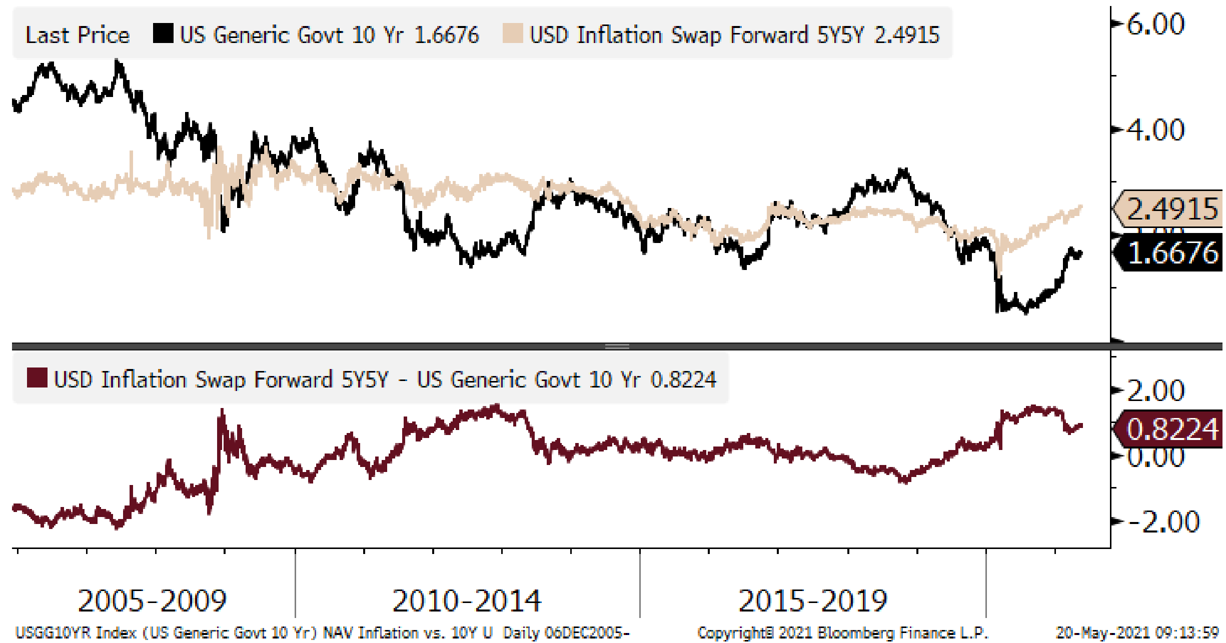
Interest rate level (indicator --) / Spreads (indicator -)

Assessment unchanged / Assessment unchanged

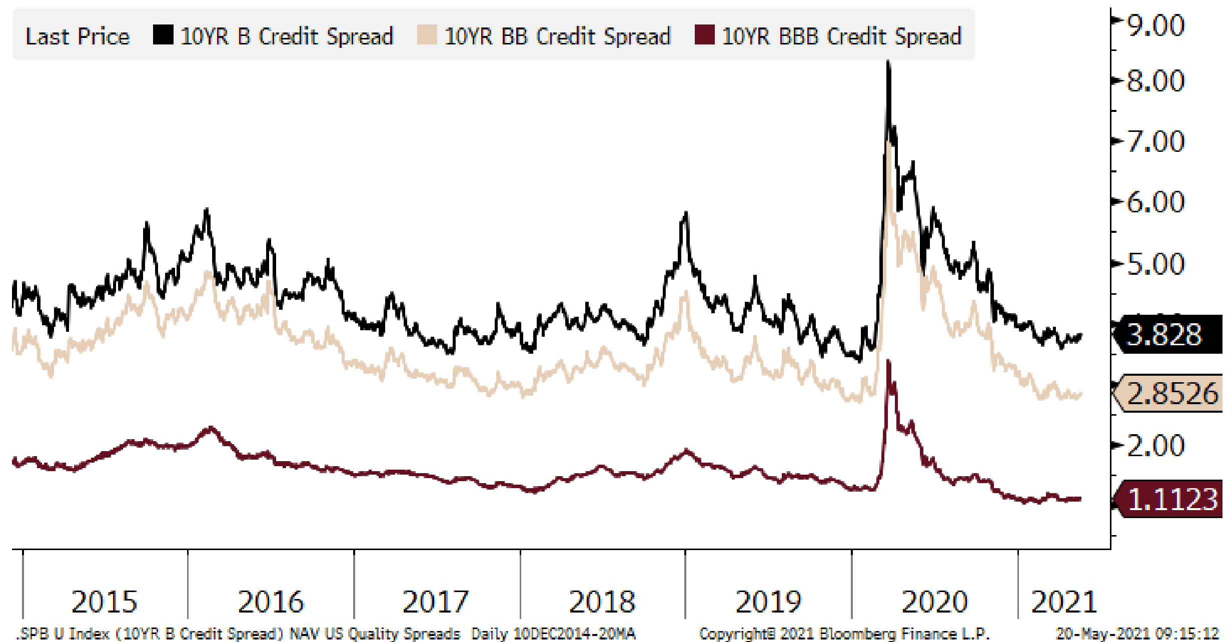
Over the last month, US interest rates have stabilized at current levels, while European interest rates have reached new highs for the year. In absolute terms, interest rates remain unattractive.



US inflation data, which exceeded analysts' expectations, did not trigger any major reaction on the bond market. This also reflects various central bank statements, that highlight a temporary effect on inflation. Although there was no jump in US interest rates, upcoming data could lead to an overshooting of interest rates. Thus, we continue to avoid longer dated maturities.



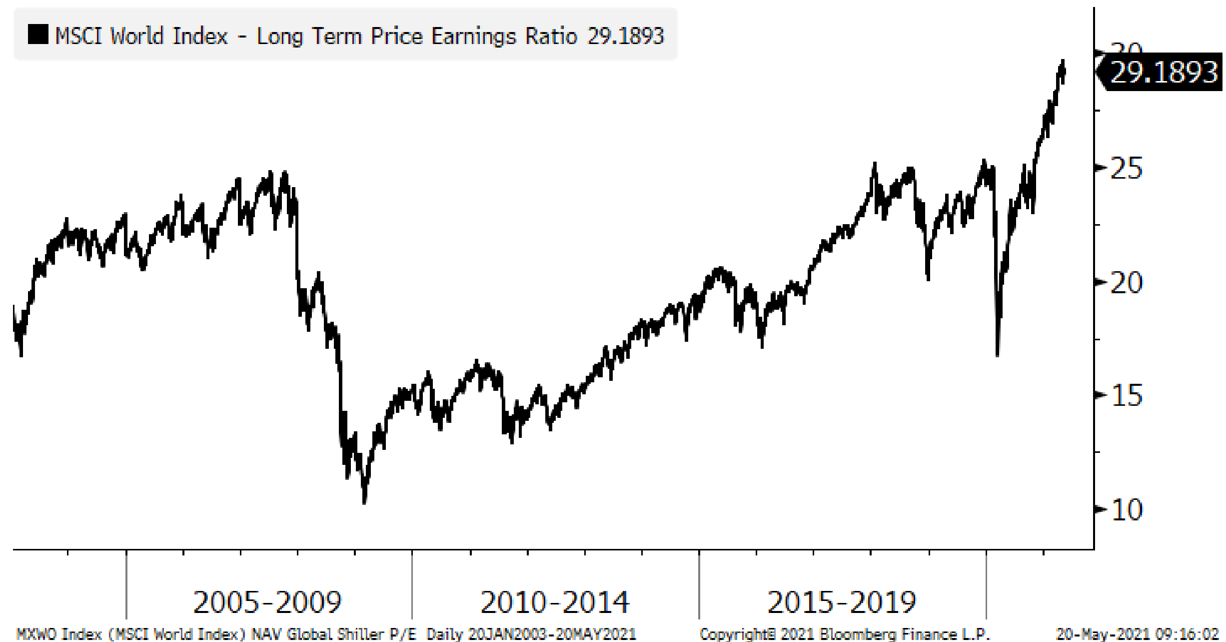
Credit spreads for all corporate grades remain at low levels and are unattractive by historical means.

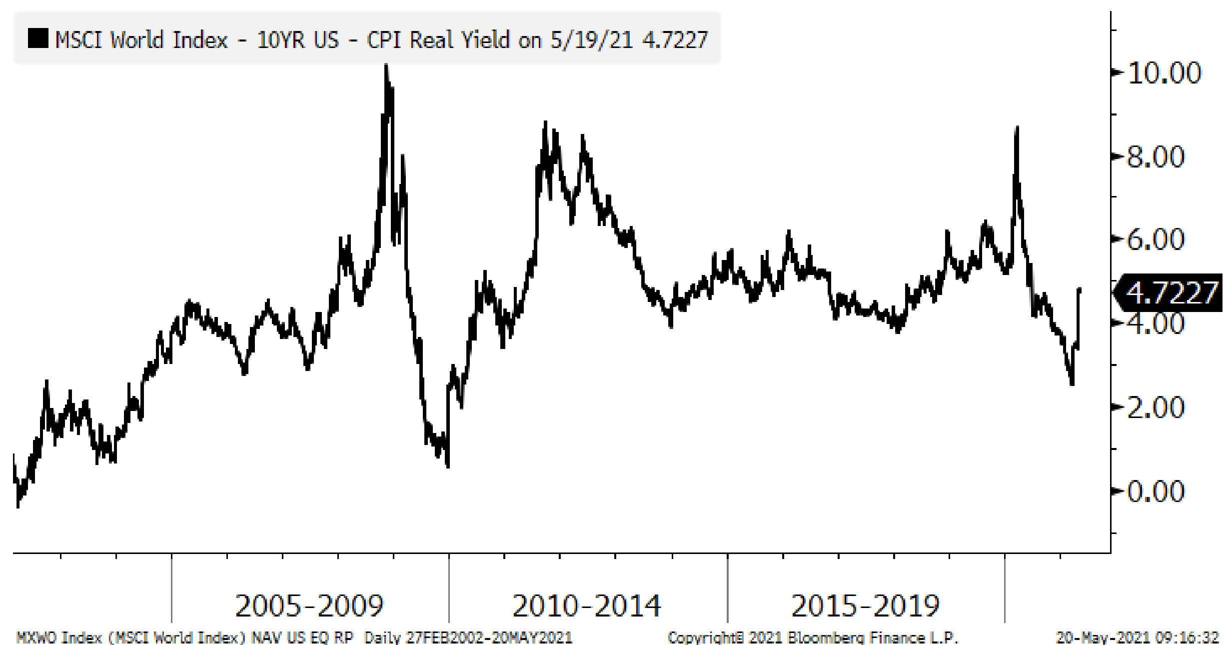


Shiller P/E ratio (indicator --) / Risk premium (indicator 0)

Assessment unchanged / Assessment increased to 0 from -

At the beginning of the month, global equity markets reached new record highs and the Shiller price/earnings ratio increased accordingly. Therfore, absolute valuation remains unattractive. In terms of risk premium, inflation data out of the US led to a positive change of the indicator that now gives a neutral signal.





Macro leading indicators (indicator +)

Assessment unchanged

Leading indicators are developing in lockstep with the respective country's vaccination progress, especially in Europe. The outlook for services in the UK provides a perspective for the rest of Europe, where vaccination coverage should lead to steadily improving data.

	31.08.2019	30.09.2019	31.10.2019	30.11.2019	31.12.2019	31.01.2020	29.02.2020	31.03.2020	30.04.2020	31.05.2020	30.06.2020	31.07.2020	31.08.2020	30.09.2020	31.10.2020	30.11.2020	31.12.2020	31.01.2021	28.02.2021	31.03.2021	30.04.2021	31.05.2021
World	51.8	51.3	50.9	51.6	51.9	52.7	47.1	36.8	23.7	35.2	48.1	50.7	52	52	52.9	52.2	51.8	51.6	52.8	54.7	56.6	
United States Markit	50.7	50.9	50.6	51.6	52.8	53.4	49.4	39.8	26.7	37.5	47.9	50	55	54.6	56.9	58.4	54.8	58.3	59.8	60.4	64.7	
Eurozone	53.5	51.6	52.2	51.9	52.8	52.5	52.6	26.4	12	30.5	48.3	54.7	50.5	48	46.9	41.7	46.4	45.4	45.7	49.6	50.5	
Germany	54.8	51.4	51.6	51.7	52.9	54.2	52.5	31.7	16.2	32.6	47.3	55.6	52.5	50.6	49.5	46.0	47.0	46.7	45.7	51.5	49.9	
United Kingdom	50.6	49.5	50	49.3	50	53.9	53.2	34.5	13.4	29	47.1	56.5	58.8	56.1	51.4	47.6	49.4	39.5	49.5	56.3	61.0	
France	53.4	51.1	52.9	52.2	52.4	51	52.5	27.4	10.2	31.1	50.7	57.3	51.5	47.5	46.5	38.8	49.1	47.3	45.6	48.2	50.3	
Italy	50.6	51.4	52.2	50.4	51.1	51.4	52.1	17.4	10.8	28.9	46.4	51.6	47.1	48.8	46.7	39.4	39.7	44.7	48.8	48.6	47.3	
Spain	54.3	53.3	52.7	53.2	54.9	52.3	52.1	23	7.1	27.9	50.2	51.9	47.7	42.4	41.4	39.5	48.0	41.7	43.1	48.1	54.6	
Switzerland	54.9	55.8	54.5	52.6	51.3	57.3	51.9	28.1	21.4	37.4	49	50.9	50.5	53.6	50.3	48.4	49.5	49.1	52.0	55.5	57.6	
China	52.5	53	51.4	53.5	53	53.1	30.1	51.8	52.1	52.3	53.4	53.1	54.3	55.2	55.5	55.7	54.8	51.1	50.8	55.2	54.4	
Japan	53.3	52.8	49.7	50.3	49.4	51	46.8	33.8	21.5	26.5	45	45.4	45	46.9	47.7	47.8	47.7	46.1	46.3	48.3	49.5	

Risk index (indicator -)

Assessment unchanged

Despite this year's record inflows into equities, a flattening momentum caused the countercyclical risk index to decline slightly since February. Although market participants hold a large allocation in equities, the indicator does not point at exaggerated euphoria and thus remains at the current, slightly negative assessment.

Appendix:

The Navigator is the central tool for our investment allocation. We use it to systematically and consistently assess the aspects that are relevant to the development of the financial markets. As a result, our clients can rely on a rational and anti-cyclical implementation of our investment decisions.

- Focusing on the essentials: Interest rate level, risk premium, valuation, economic development, investor sentiment and positioning. These are the decisive factors for success on the financial markets, especially in turbulent times when the temptation to react irrationally to the headlines is particularly strong.
- Comparability over time and place: The factors mentioned above are equally relevant for all markets and at all times. This is the result of a strict «backtesting» process that continues into the future.
- Cumulating our investment experience: Our strength lies in the many years of experience of our partners and principals. It is precisely this experience that we summarize and make applicable with our Navigator.
- Transparency: Thanks to our monthly publication, our clients always know where we stand in the investment cycle and how we expect the financial markets to develop.

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