soundcapital

US consumer prices jump most since 2008

July 2021

- Equity risk premium rises again
- Growth momentum in the US has probably passed its peak
- Investors less positive despite rising share prices
- Unchanged investment categories
- US equities raised to neutral

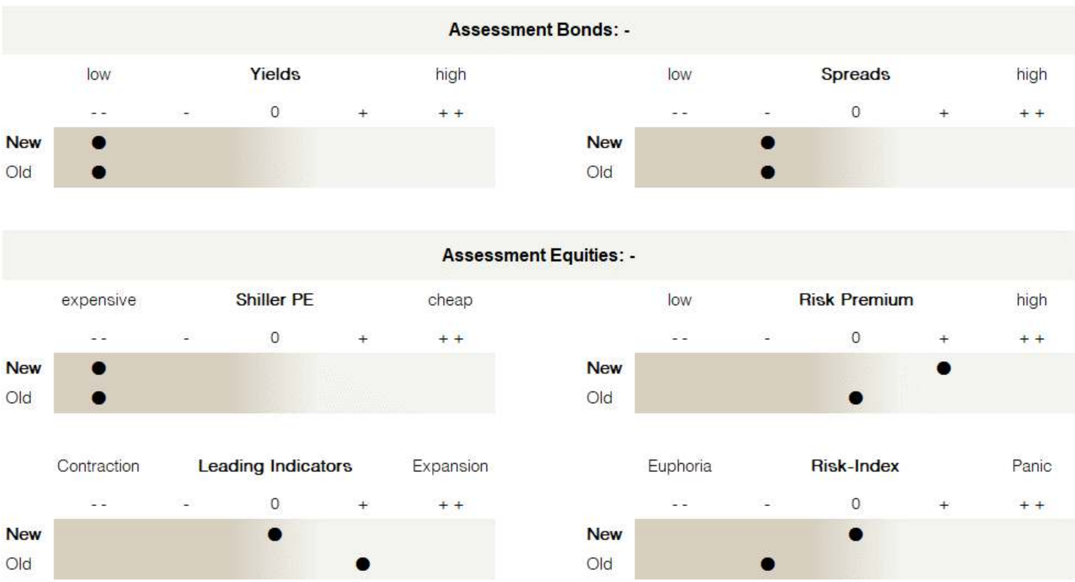
Capital markets react unimpressed

In June, the US inflation rate spiked more than 5.4% year over year. At first glance, this seems to confirm the trend towards an accelerated increase in consumer prices. However, as already reported in our last publication, the strong increase does not come as a surprise. A large part of it is likely to be attributable to a base effect of the heavily impacted pandemic months in the first half of 2020 and therefore a significant distortion from the trend inflation rate.

Despite the high inflation number, the U.S. capital market reacted unimpressed. The inflation swap, which tracks future inflation expectations, fell by 0.3% from last month. Furthermore, the equity market seems to shrug off the issue of a longer lasting period of inflation for the time being. This is reflected by the significantly better performance of sectors benefiting from moderate economic growth, low inflation and an expansionary monetary policy. Hence, it does not come as a surprise that growth stocks have again benefited significantly, while value stocks seem to be out of favor in this environment.

However, looking beyond the horizon, inflation remains topical for investors. It is becoming apparent that governments, supported by their central banks, are pursuing a repression policy to reduce debt. A tendency to higher inflation with low or even negative nominal interest rates causes strongly negative real interest rates. In the long run, this leads to a deleveraging of government debt at the expense of savers. Anyone who does not want to become a victim of this policy will be forced to put savings into real assets such as equities or gold. The often-cited lack of alternatives supporting these asset classes is thus likely to prove true, at least in the medium to longer term.

In this context, the relative valuation of equities versus bonds has already improved due to higher inflation rates. The risk premium has risen significantly and is now making a positive contribution to the overall assessment of equities.



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It may come as a surprise that we upgraded the risk index to a neutral range, which is due to a data-based change in the interpretation of this indicator. A re-evaluation of relevant data has shown that decisions with a high degree of accuracy are only possible within the extreme areas of the indicator. Thus, the indicator makes a strongly negative contribution to the overall assessment in the case of clearly observable euphoria and greed, and a strongly positive contribution in the case of clearly visible depression and fear among investors. Neither of these is currently the case.

A different picture emerges for the leading indicators, which do not provide a positive but only a neutral contribution to the assessment. Although the economic trend is still positive, its momentum has probably peaked. After reaching a turning point, this indicator is usually not supportive for equities, despite continuous positive values.

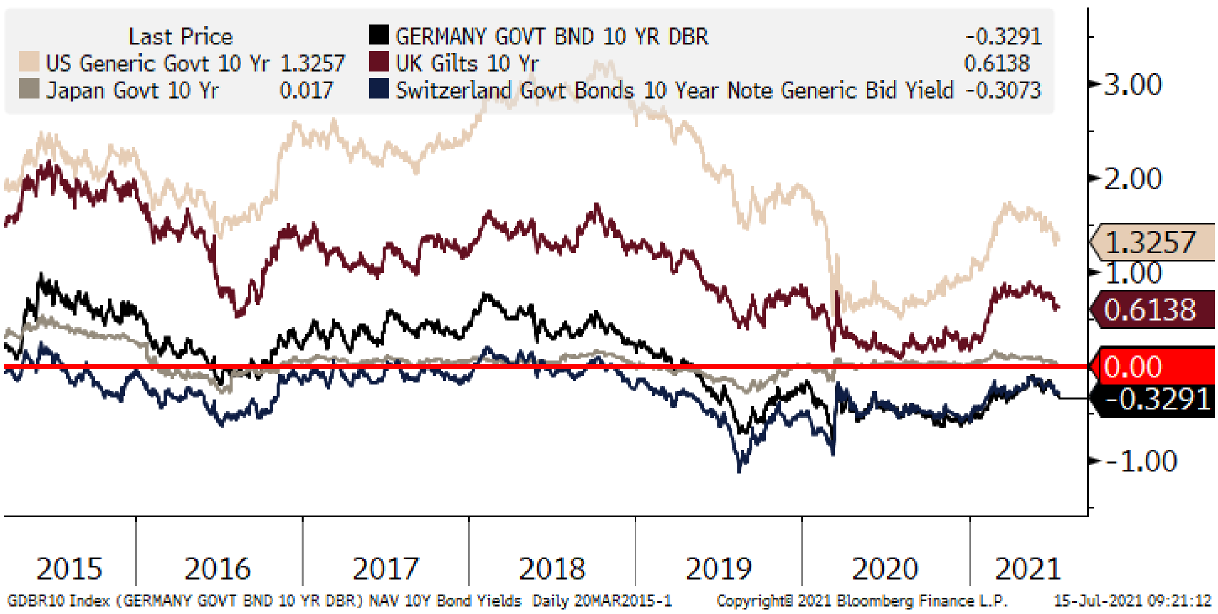
Although the assessment of equities is again somewhat more positive, it is not yet enough to upgrade it from slightly underweight to a neutral weight. However, it will probably only take a small market correction for our dataset to swing in favor of equities.

Due to the high weight of growth sensitive equities in the US, we have decided to upgrade the region to neutral from negative.

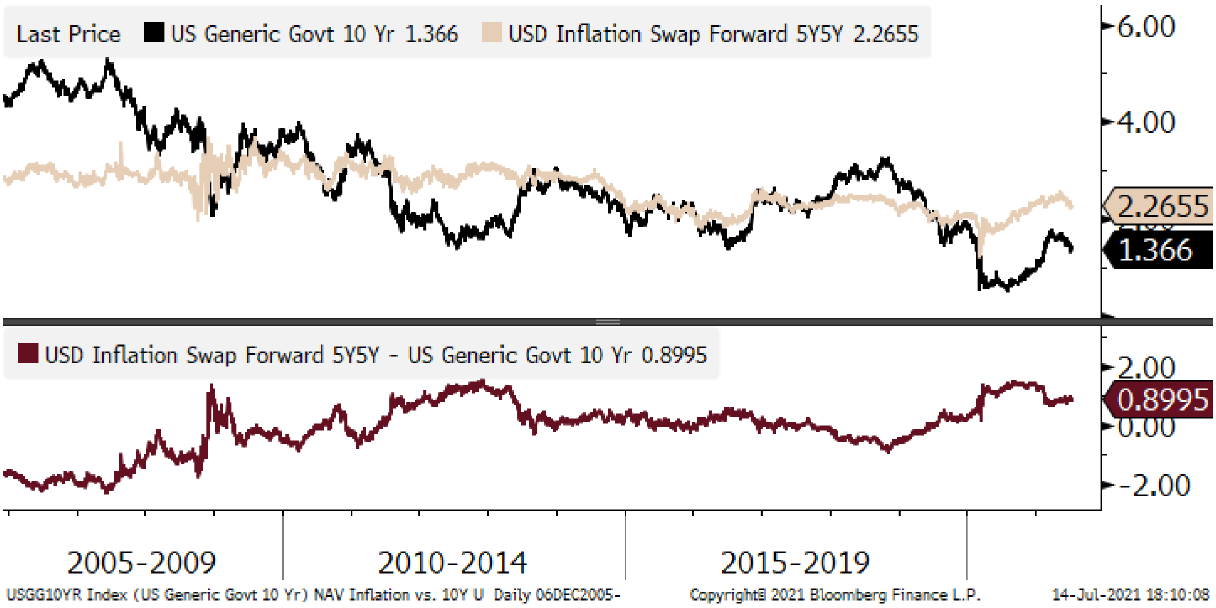
Interest rate level (indicator --) / Spreads (indicator -)

Assessment unchanged / Assessment unchanged

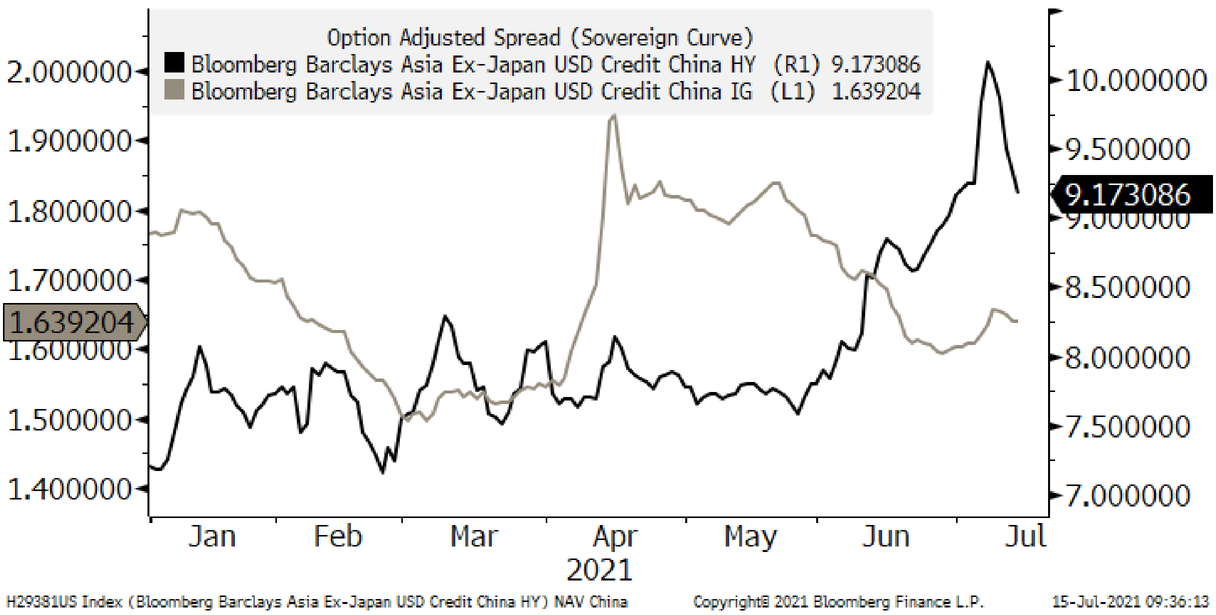
Although inflation numbers were strongly above economists' expectations, the capital market is giving the all-clear if one looks at the longer end of the yield curve. 10-year government bond yields have declined since the last publication and remain at an unattractive level.



Future inflation expectations, as measured by the U.S. inflation swap, also point to a transitory period of the rise in consumer prices. Nevertheless, nominal government bond yields have fallen more than inflation expectations, causing expected real yields to decline.



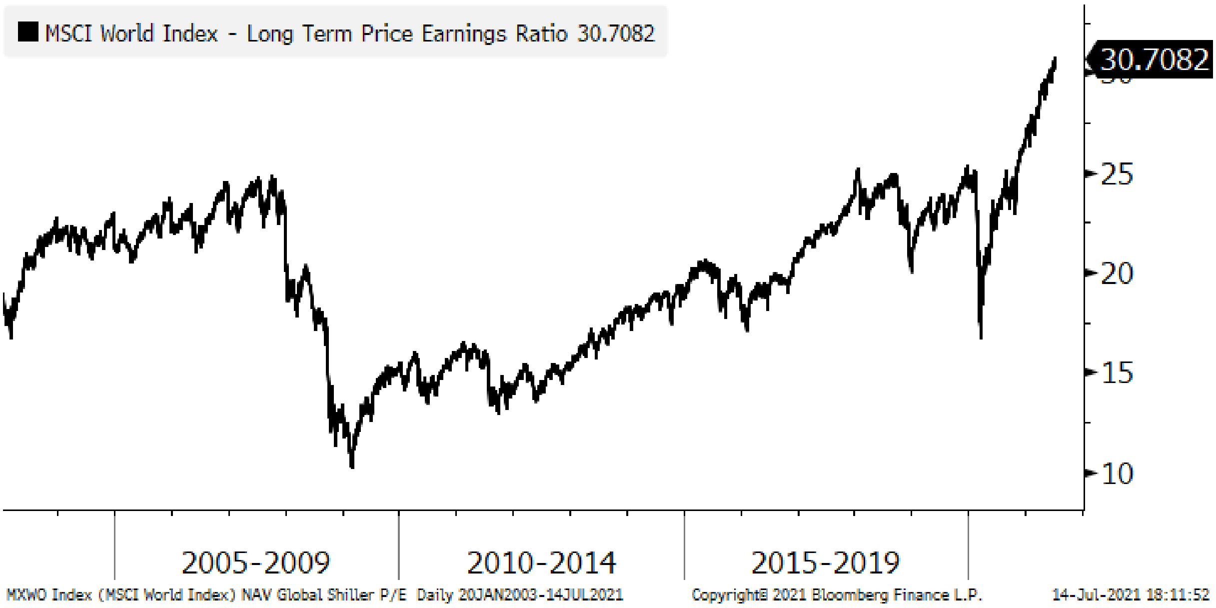
While there has been some movement in nominal yields, credit spreads across the board have remained largely unchanged since our last report. What caught our attention were credit spreads on high-yield bonds in China, which have moved in contrast to the rest of the market as the sovereign guarantee of highly leveraged local institutions is questioned by the market. Generally higher spreads for emerging market bonds are the reason why we continue to favor the region.



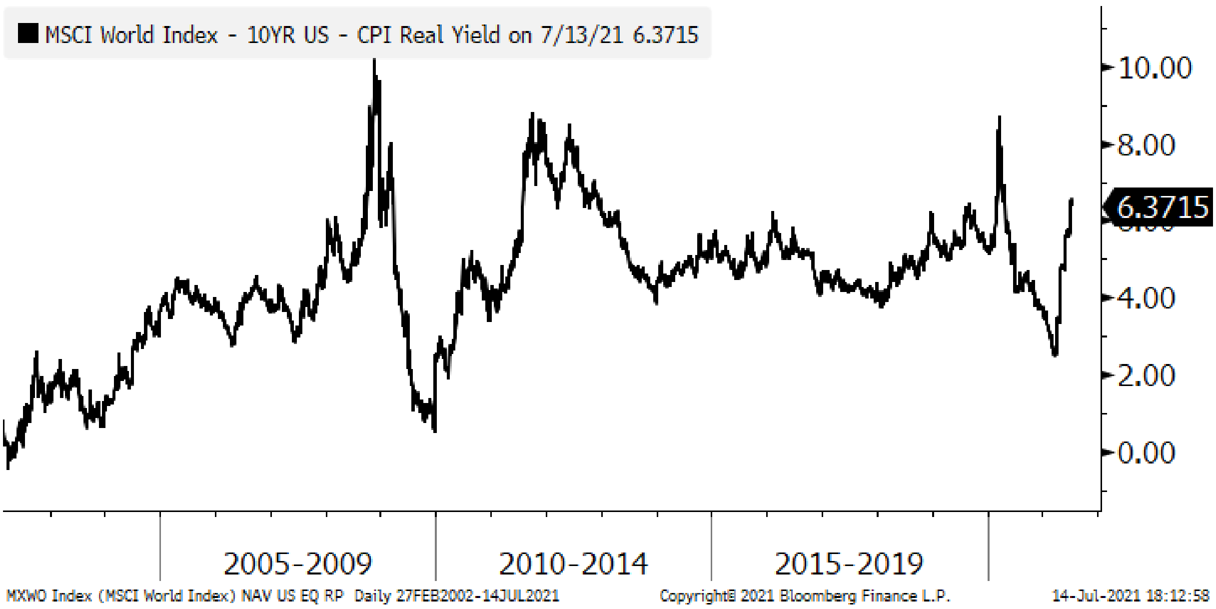
Shiller P/E ratio (indicator --) / Risk premium (indicator +)

Assessment unchanged / Assessment increased to + from 0

New all-time highs for major equity indices caused the cyclically adjusted price/earnings ratio to rise further. Thus, the Shiller P/E ratio remains unattractive



On the other hand, lower real interest rates caused risk premiums for equities to rise further and lead to a positive contribution. However, the expectation of transitory inflation must also be considered and leads to an overall unchanged assessment of equities.



Macro leading indicators (indicator 0)

Assessment decreased to 0 from +

When looking at global leading indicators, it looks like a trend reversal is slowly emerging. While most surveys show a reading above 50 and still point at an expanding economy, declining momentum usually does not support further equity market gains.

	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	30.06.2021
Weltweit	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	57.0	59.6	57.5
USA	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	70.4	64.6
Europa	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	55.2	58.3
Deutschland	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	47.0	46.7	45.7	51.5	49.9	52.8	57.5
UK	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	62.9	62.4
Frankreich	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	56.6	57.8
Italien	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	53.1	56.7
Spanien	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	59.4	62.5
Schweiz	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	58.8	64.4
China	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	54.3	52.3
Japan	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	46.5	48.0

Risk index (indicator 0)

Assessment increased to 0 from -

A renewed evaluation of the risk index data has shown that decisions with high accuracy are only possible if the index reaches extreme values. According to this new assessment, the index is thus in the neutral range.

Appendix:

Sound Invest 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.