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Financial Repression

Inflation overshoots as central banks continue to buy bonds

The term "stagflation" (stagnating economic growth coupled with rising prices) has a record high usage on internet search engines. In order to increase readership, media outlets once again focus on the worst possible outcome as a clickbait. The same happened in the first quarter of 2020 when negative media coverage took over. But things can turn out differently than one thinks which is highlighted for example by the large gap between past ECB inflation forecasts and the realized inflation rates. In case of economic and financial market data, forecasts often adapt to reality. For this reason, we prefer to deal with available data rather than a blurry future projection.

In the US, consumer prices are up more than 5% year-on-year for the fifth consecutive time. Therefore, the base effect induced by "lockdowns" can no longer serve as the only factor behind the price increase. Rising energy and commodity prices, supply chain disruptions and, in particular, a shortage of microchips are holding back economic development and are influencing percepti-ons regarding future inflation trends. Thus, inflation seems to have taken hold (almost) everywhere. Even the fear of so-called second-round effects (vicious circle in which rising inflation leads to rising wage demand that fuel each other) seems to be manifesting itself to some extent, although this phenomenon has so far mainly been observed among low-income classes.

Even though the situation looks threatening, central banks play for time and stick to their narrative of transitory inflation. This attitude has not only been underlined verbally, but also actively with the ongoing asset purchase programs (quantitative easing).

Although a gradual reduction of the purchase program by the FED is expected to start as soon as next month, it can be assumed that the central banks will keep providing substantial support for bond markets and ultimately risk assets for the time being. It comes as no surprise that as a result of the seemingly lax central bank policy, inflation expectations have climbed. While the expected real interest rate on US government bonds over the next 10 years trades around -1% (hovering around the lower end of the long-term trading range), levels have fallen to a record low of -2.2% in Europe. Obviously, there is a fear that the European governments intend to use negative real interest rates to reduce debt in the long run to the disadvantage of savers. A dangerous game: once a central bank has lost control of inflation expectations, a disproportionately restrictive monetary policy is necessary to contain overshooting inflation. In order to bring under control the excessive inflation in the 1970s, former FED chairman Paul Volcker had to raise US interest rates to 20% at the beginning of the 1980s.

A comparison with the past shows how dangerous it can be to play down the risk of inflation. Only by accepting a severe recession, central banks were able to tame galloping inflation. But is the current situation really comparable to the 1970s? Probably not! The debt burden of developed countries nowadays suggests that a comparable interest rate level like before the great financial crisis is hardly realistic under the current circumstances. In the US, the ratio of outstanding national debt to gross domestic product has risen from 33% in the 70s to over 125% today. Moreover, economic dependence on the oil price has also decreased significantly. Furthermore, Inflation is less driven by excessive demand (which could be slowed down by the central bank with a more restrictive monetary policy) but rather by insufficient supply due to supply chain bottlenecks. So far activity has normalized in many parts of the economy in the aftermath of the pandemic. Following this pattern, the delivery bottlenecks could well be resolved.

Thus, it is quite reasonable to think that the inflation rate will fall again in the middle of next year as deflationary forces like digitization are still present. Moreover, inventories of US companies are well below average, which means that the inventory cycle could also work in favor of future US economic growth. Last but not least, it cannot be ruled out that rising personnel costs could lead to investments in rationalization measures. In other words: for people familiar with the "hog cycle", a shortage of microchips, for example, is often followed by an oversupply with consequently falling prices.

What does all of this mean for the positioning across different asset classes?

Fixed-income investments of high credit quality have unattractive nominal yields and, in most cases, negative real interest rates. In the event of rising inflation rates and, at best, interest rates capped by central banks, there is a threat of creeping expropriation (financial repression) or, in the event of rising interest rates, hefty capital losses.

Interest rate risk must be avoided

Nevertheless, attractive risk premiums can generate returns that exceed current inflation expectations. In most developed markets, however, credit spreads have fallen to historic lows, which is why we tend to be cautious in this segment. The exception is Asia, where high-yield bond spreads have reached historic highs. A spillover from the Chinese real estate market to issuers in less affected countries and sectors can be observed. We expect these spreads to normalize again, which is why we are considering Asian high-yield bonds for our discretionary mandates.

In our view, quality leadership will outperform cost leadership

Equities do not serve as an ideal inflation protection per se. Only companies with pricing power can pass on inflation-related cost increases and maintain attractive profit margins. Negotiating power with suppliers is also important. Good management also guarantees flexibility in procurement, production and sales. Good management also attracts good people. Competition for talented, motivated and highly qualified employees has been in full swing for some time.

First-class companies are gaining market share in difficult times, while structurally weak competitors are being squeezed out. More generally, economic reality is likely to take the mainstage over economic fantasy again. This should also benefit markets with attractive valuation such as Japan. In addition to a compelling valuation, the sharp rise in earnings expectations and the increasing success of the local vaccination campaign, which is trickling through to the local leading indicators, are the key factors behind our slight overweight of Japanese equities.

Under certain circumstances, gold is a good inflation hedge

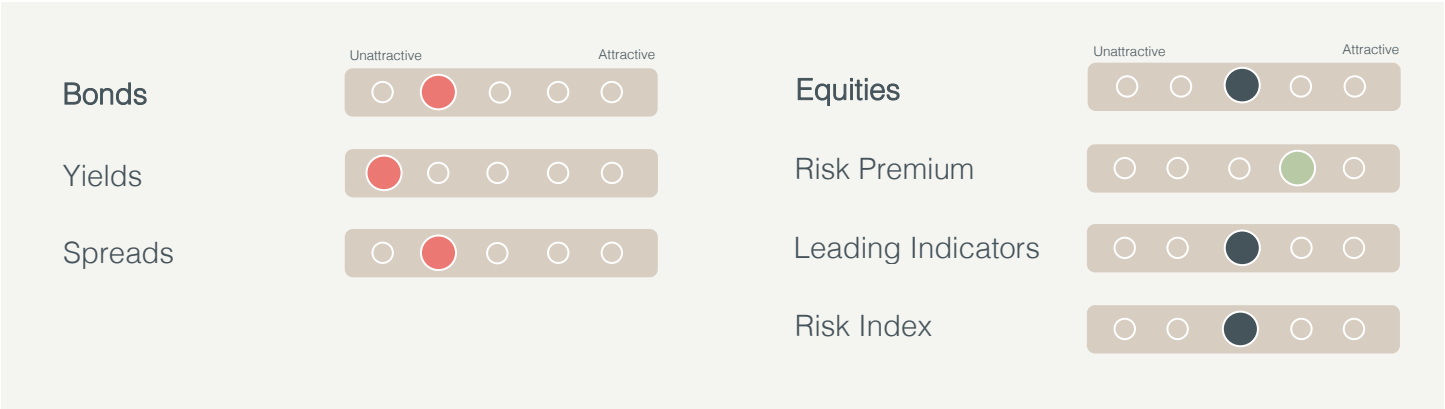
Since gold does not pay interest or dividends, an investment in precious metals always competes with a fixed-income investment. With low nominal and especially negative real interest rates, there is no opportunity cost to holding gold in the form of foregone interest. In this respect, the financial repression sought by central banks creates ideal conditions for gold.

Alternative investments close the gap

Alternative investments, such as hedge funds, fill the gap left by the underweighting of unattractive fixed-income investments. At this point, it is also worth highlighting real estate, which is considered to be particularly resistant to inflation. Like fixed-income investments, real estate is very sensitive to changes in interest rates, which is why valuations can fall sharply when interest rates rise. Moreover, there is a risk of government intervention, which could lead to a "cap" on rents. Under this regime, inflation-related rent increases could no longer be passed on to the tenant, which would reduce the real value of rents.

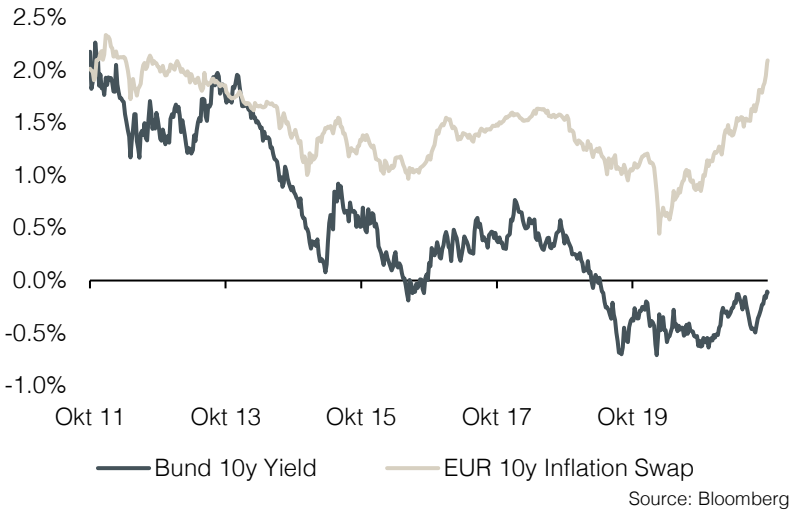
Diversification as a key element

Especially under current circumstances, a broadly diversified and robust portfolio, which can offer attractive returns with a manageable risk, regardless of the expected scenario is strongly recommended.



Yields

EU nominal yield vs inflation expectation



Source: Bloomberg

View:

Global interest rates could not escape from rising inflation expectations in October. Accompanied by the first interest rate hikes by the central banks of New Zealand and Norway, global interest rates increased. The discrepancy between expected inflation and nominal yields on 10-year government bonds in Europe is striking: while inflation expectations have reached their highest level since 2014, yields on German government bonds remain in negative territory. The market obviously sees little risk of inflation getting out of hand for an extended period of time. Nevertheless, central banks and their bond purchases are likely to contribute significantly to this distortion.

Spreads

High Yield Spreads (in bps)

Source: Bloomberg

View:

In developed markets, credit spreads remain at very low levels, which is why our assessment for the asset class as a whole has not changed. Credit spreads for high-yield bonds in Asia have widened again compared to last month. We note that even excluding issuers related to the Chinese real estate market, credit spreads have increased sharply. We see the current pick-up in Asia as an opportunity as we expect a normalization. For this reason, we upgrade Asian high-yield bonds to neutral from strongly underweight.

Equity Risk Premium

Global Equity Risk Premium

View:

The equity risk premium (intended to compensate investors over a longer investment horizon for additional risk compared to the risk-free rate), remains attractive. Despite some market turbulence in September, there were no major changes to the equity risk premium.

Leading Indicators

We maintain a neutral assessment, which considers the declining momentum of global purchasing managers' indices. In some countries, numbers improved somewhat compared to the previous month, but we reckon that COVID-19 increases economic uncertainty, especially during the winter months. Thanks to high-frequency data sets, we can analyze the situation very closely. We look at passenger numbers, restaurant bookings and commuter traffic for an early identification of trends.

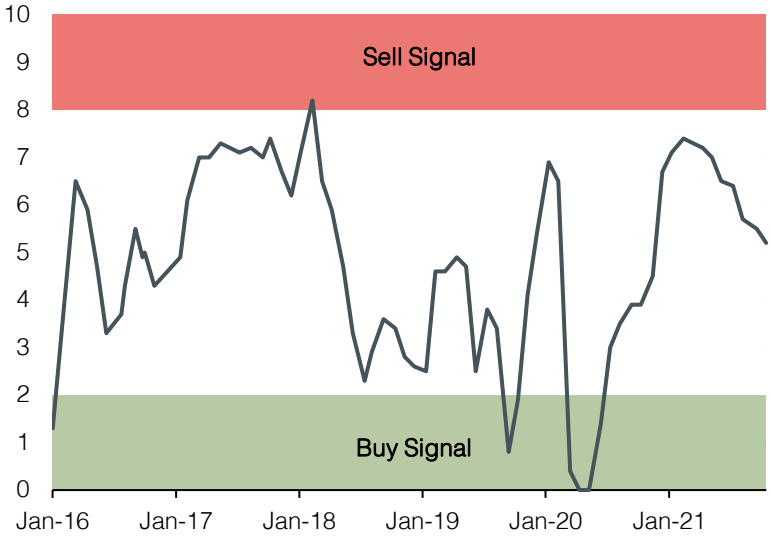
View:

Services PMI

	Jan-20	Feb-20	Mar-20	Apr-20	May-20	Jun-20	Jul-20	Aug-20	Sep-20	Oct-20	Nov-20	Dec-20	Jan-21	Feb-21	Mar-21	Apr-21	May-21	Jun-21	Jul-21	Aug-21	Sep-21	Oct-21
World	52.7	47.1	36.8	23.7	35.2	48.1	50.7	52.0	52.0	52.9	52.2	51.8	51.6	52.8	54.7	57.0	59.5	57.4	56.3	52.8	53.4	
United States Markit	53.4	49.4	39.8	26.7	37.5	47.9	50.0	55.0	54.6	56.9	58.4	54.8	58.3	59.8	60.4	64.7	70.4	64.6	59.9	55.1	54.9	58.2
Eurozone	52.5	52.6	26.4	12.0	30.5	48.3	54.7	50.5	48.0	46.9	41.7	46.4	45.4	45.7	49.6	50.5	55.2	58.3	59.8	59.0	56.4	54.7
Germany	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	52.8	57.5	61.8	60.8	56.2	52.4
United Kingdom	53.9	53.2	34.5	13.4	29.0	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	59.6	55.0	55.4	58.0
France	51.0	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	56.8	56.3	56.2	56.6
Italy	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	58.0	58.0	55.5	
Spain	52.3	52.1	23.0	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	61.9	60.1	56.9	
Switzerland	57.3	51.9	28.1	21.4	37.4	49.0	50.9	50.5	53.6	50.3	48.4	49.5	49.1	52.0	55.5	57.6	58.8	64.4	60.8	61.3	62.1	
China Local	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	52.5	45.2	52.4	
Japan	51.0	46.8	33.8	21.5	26.5	45.0	45.4	45.0	46.9	47.7	47.8	47.7	46.1	46.3	48.3	49.5	46.5	48.0	47.4	42.9	47.8	50.7

Description: The Purchasing Managers' Index (PMI) is a forward-looking economic indicator based on company surveys. A value above 50 indicates an improving economic environment, whereas a value below 50 indicates a worsening environment.

Risk-Index



View:

The market development in September caused the risk index to fall slightly. It remains in neutral territory and reflects a positioning of investors that is neither euphoric nor fearful. However, strong inflows into equities after the correction in September caught our attention. Investors still seem to keep a lot of cash on the sidelines waiting for lower entry levels.

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 it applicable with Sound Invest.
- **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.

Datasource: Bloomberg, BofA ML Research