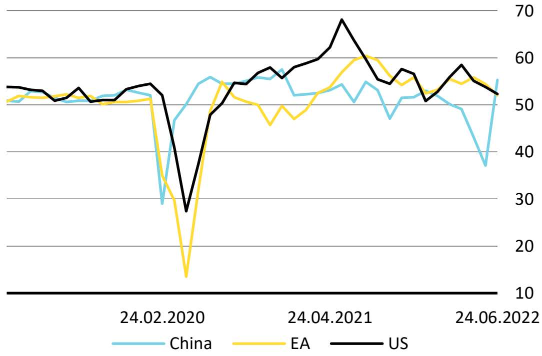
Investment Outlook

Elevated inflation and mid-term search for stronger economic resilience

Equity markets posted positive returns since the end of July at least until recently. Gradually declining inflation rates in the US and significant measures to fight inflation by many central banks in the advanced economies have helped to spur risk assets. In addition, academic research confirmed the notion of the Federal Reserve Bank that the natural rate of unemployment is close to the current unemployment rate. This should limit the necessity of the Fed to hike rates substantially to bring inflation under control. Therefore, we keep our equity exposure close to the strategic allocation.

Economic and market views summer 2022
Since the start of the second semester of 2022, we have experienced a solid recovery in global financial markets. Global equities have gained nearly 10% (in USD), after losing around 22% during the first half of the year. At the same time, the broad USD index is basically unchanged since the end of June, while the greenback has appreciated strongly, by approximately 12%, since the start of the year. Fixed income and credit markets have also felt the pain of decelerating economic momentum and rising inflation. Most purchasing manager indices (PMI) for advanced economies have fallen by about 5 to 10 index points since spring 2022, indicating a significant slowing of economic activity around the world while continuing to show expansion.

Purchasing manager indices (PMI Composite) – Remaining strong (Index Points)



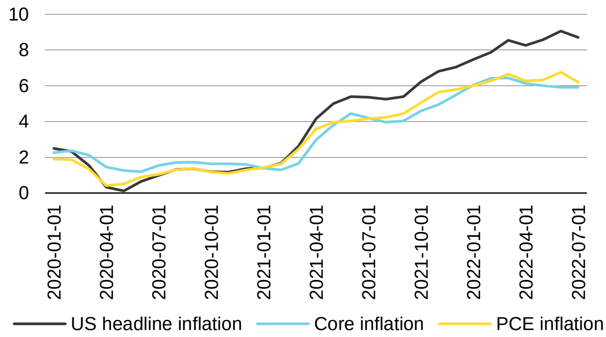
Source: Bloomberg, Vontobel SFA, as of July 2022

In the US, the yield curve was flattened by the US central bank's aggressive rate hiking, which raised central bank rates by a total of 225 basis points to combat persistent high inflation. The slope of the euro area (EA) government bond yield curve remained in positive territory as the European Central Bank acted with much more caution to reverse the trend of their interest rate policy over the past decade, but surprised market participants in July by hiking their central bank rate by 50 basis points versus the expectation of a quarter point.

What might have changed since early summer? – Heresy!
Looking to the positive market sentiment over the recent weeks, we have asked ourselves what might have triggered a change in the expectations of future inflation and monetary policy that has prompted risk assets to reverse to a positive performance since the beginning of June? We have taken a closer look at the recent inflation trends, particularly in the US, analyzed the US central bank's very recent rhetoric and communications, and put together these pieces of the puzzle into an historical and analytical framework.

Let's start with a look at the short-term inflation dynamics in the US. It seems that most indicators of consumer (CPI) and producer price (PPI) inflation have started to plateau. CPI inflation, excluding the volatile prices of energy and food, started to decline moderately and fell below 6% in July. The Personal Consumption Expenditure price index dropped to 6.2% in July after 6.8% in June. At the same time, producer price inflation even dropped into negative territory in July. CPI inflation including energy and food, however, remains elevated at 8.7% but was also down by 0.4 percentage points. These encouraging inflation trends could have been taken by investors as confirmation of their view that inflation may be surprisingly high but that it is a temporary phenomenon.

Recent trends in US consumer inflation (in %)



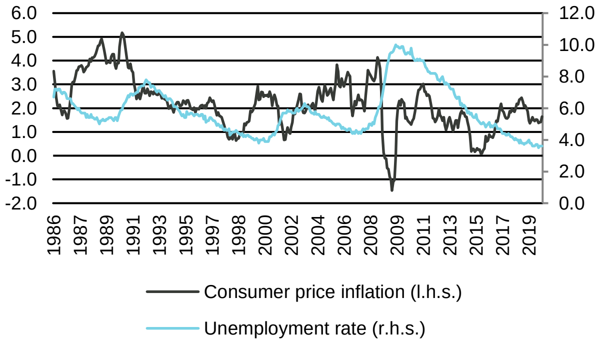
Source: Federal Reserve Bank St. Louis, Vontobel SFA

Let's move on to investigate the implications of the Fed's most recent rhetoric on the expected future path of US central bank rates. They and many other central banks now seem to be united in favor of a steep hike in the Fed's policy rate, as we witnessed with the most recent 0.75% jump. Moreover, we are told that there are many more increases to come, since the Fed rate is, supposedly, still well below its "neutral" level. For a very recent plea in support of what may have been the "mother" of rate hikes in the United States, namely another "Volcker shock", one only has to peruse recent papers by notable American economists such as Larry Summers, the former US Treasurer and Professor at Harvard University, in which he suggests that, to get the current inflation rate down to align with the US Fed's 2% inflation target, it would now "require nearly the same amount of disinflation as achieved under Chairman Volcker." To put this statement into perspective, the effective Fed funds rate for the period of 1980 to the end of 1985 averaged nearly 11.5%. The mean of the effective rate has been at around 1% since the Fed started to hike rates in March 2022.

A recently published working paper by two Fed economists entitled "Who Killed the Phillips Curve? A Murder Mystery" concluded that "interest rate hikes could have helped to reduce inflation, but it was rather the declining bargaining power of trade unions over the past four decades that was behind the inflation debacle of the Great Moderation, which had long-term consequences." Putting it that way, this could sound quite subversive to many mainstream economists. Indeed, as Nick Peterson wrote in the Financial Times: "Coming from deep inside the Fed (the two economists) this is near heresy. After all, central banks have naturally long been in thrall to theories that made them the heroes of the story." So, what makes the findings of this working paper heresy?

The main takeaway of this research paper written by the US Federal Reserve economists is that a repeat of the anti-inflation policy scenario of the early 1980s of sharply raising central bank interest rates might prove an inappropriate, if not a catastrophic, solution for dealing with the current inflationary environment. While inflation is hurting the poor disproportionally more because of their low incomes, a steep across-the-board rate hike may be a remedy that is worse than the disease, for we are not primarily facing demand-side inflation, a state of affairs we have highlighted several times over the past months. For rising central bank rates to have a meaningful impact on inflation, there must by a strong negative correlation between a change in inflation and a change in the growth in demand. Higher demand and rising employment initiate via higher wage rates accelerating inflation and vice versa. If demand depends on the level of funding and availability of credit, the central bank will have a material impact on inflation: higher central bank rates make credit and funding more expensive, reduce the demand for credit, and dampen demand for goods and services, causing inflation to decelerate. The stronger this negative relationship between inflation and unemployment, the more successful monetary policy will be by steering the overall inflation process.

US inflation and unemployment (in %)



Source: Federal Reserve Bank St. Louis, Vontobel SFA

But what if this assumed strong negative relationship between inflation and unemployment has structurally reduced or even disappeared over time? First, empirical studies have shown that this trade-off has significantly weakened in most advanced economies, especially in the US and the UK over the past 40 years. As a result, evidence-based economics would suggest that the well-worn relation between unemployment and inflation does not actually exist in the form it is traditionally depicted by “mainstream economists.” Some simple correlation calculations reveal that the trade-off between inflation and unemployment is strongly time variant. For the period between 1960 to the end of 2019, the correlation coefficient is -0.07. An increase of one percentage point in unemployment lowers inflation by 0.07%. By restricting the analysis to the period from 1965 to 1985, which includes the start of the Great Moderation (high employment, low inflation), the correlation increases to 0.35 and then drops again to below 0.15, showing even the wrong direction. This indicates that this relationship may have become obsolete. In this case, economists refer to a flat Phillips curve, as this relationship was empirically established by the economist Alban Phillips in 1958. Regardless of what the main reasons are for the current missing link between inflation and unemployment, strong interest rate increases initiated by tighter monetary policy would be the wrong remedy for a temporary inflation shock. Higher rates would only mean higher unemployment, causing a severe economic slowdown, while inflation, all things being equal, will stay elevated. Under these circumstances, a central bank that tries to combat **in**flation will create **stag**flation.

Mid-term search for more resilient supply and production chains: even more inflation in the pipeline?
Over the medium-term, we have identified some trends that might have a meaningful impact on the stance of future monetary policy, as these geopolitical and behavioral trends may change future inflation. These trends are the result of the move from a unipolar to a bi- or even multi-polar world. This fracturing is already underway with the emergence of China as a major economic and political power. In a more fractured world, governments and corporate decision-makers may increasingly focus on searching for safety and start building more resilience in their supply and production chains.
With the risk of military conflicts more real following the Russian intervention in Ukraine, many Western governments, especially those in Europe, have announced plans to increase defense spending and invest into energy (mainly renewables) and food security.

Many companies are focused on re-establishing more resilient supply and production chains through global diversification, near-shoring and friend-shoring. These efforts were already underway in response to the US-China trade tensions and because the COVID-19 pandemic highlighted the vulnerabilities of even sophisticated global supply chains and are most likely to be intensified given the more insecure geopolitical environment.

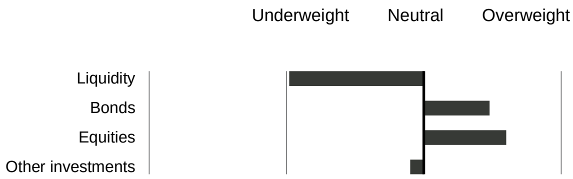
As a consequence of climate change, decarbonization and the COVID-19 crisis, many governments and companies have already increased their investment spending to mitigate and adapt to global warming and to improve health security.

In general, these trends are supportive of domestic demand, but whether these trends represent short-term inflationary tailwinds is dependent on whether these investments will foster productivity growth or not. In the case of a new process of optimizing supply and production chains in light of more resilience and safety, we believe that corporates would choose those technologies which optimize productivity gains within the respective restrictions. These additional efficiency benefits can absorb higher costs associated with stronger regulations and additional demand for labor. Furthermore, whether energy prices will increase further during the green transition will depend on the speed of the introduction of cheaper renewables and the shrinking supply of brown energy. An inflationary impact should only be expected if brown energy shrinks faster than the speed renewable energy becomes available. In general, we believe this can be steered by governmental authorities. These medium-term trends are not expected to aggravate the current dilemma of central banks of choosing between fighting inflation or supporting economic growth. The impact of these structural changes during the transition process of inflation are still very uncertain and will depend on the respective assumptions set with respect to productivity growth and the relative availability of renewable and traditional energy. Regardless of these aspects, when setting interest rates central banks should disregard temporary inflationary tailwinds created by structural changes on the supply side of an economy.

Investment conclusion: severe downturn not on the cards – we are staying invested!

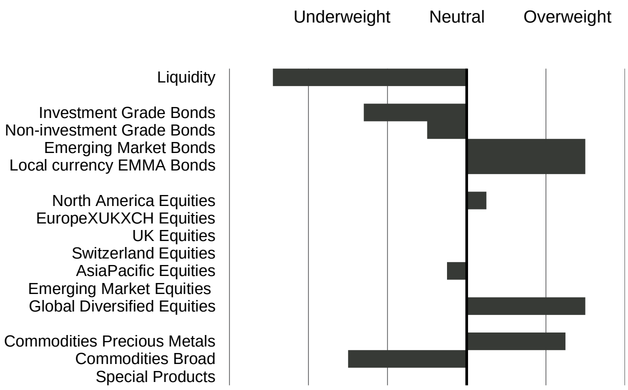
Today, it is not the question of whether the global economy is strong and resilient enough to absorb the retarding impact of supply chain disruption and falling real purchasing power due to accelerated inflation. The crucial question in dispute today is whether central banks are still convinced they can solve the current elevated level inflation by substantially reducing domestic demand, triggering a severe economic downturn and higher unemployment. In such a case, we would reduce our risk appetite and accordingly the risk exposure in our portfolios. With signs of stabilizing consumer and producer price inflation, abating supply chain disruption, rising inventories, and the fact that empirical studies are confirming that the "Non-Accelerating Inflation Rate of Unemployment" (NAIRU) is estimated to be between 4% to 4.5%, we agree with consensus expectations that the terminal federal funds rate will not go far beyond about 3.5%. It should not come as a surprise if US monetary policy goes in this direction of further gradual hiking rates. Although this means a tightening of financial conditions, especially if we consider the appreciation of the USD during this year, real short-term and long-term rates will remain in negative territory during the current and future transition period, implying favorable funding costs for the corporate and households' sectors. If unemployment stays close to the NAIRU, disposable incomes should support domestic demand, which will feed back into solid earnings growth. Based on this scenario, we are maintaining our equity exposure close to the strategic allocation. We prefer global and international diversified equity investments.

Asset class preferences



Source: Vontobel SFA, as of August 2022, based on PM Global Balanced USD

Sub-asset class preferences



Source: Vontobel SFA, as of August 2022, based on PM Global Balanced USD

In the fixed-income space, we are re-iterating the attractiveness of hard and local currency-denominated emerging market debt. Most emerging market economies are commodity exporters and should benefit from higher commodity prices, including energy. Moderate adjustments in rates in the advanced economies and a stable USD should also be supportive for investments in emerging market bonds. We continue to express a preference for investment-grade corporate bonds in the advanced economies. As we are not projecting a severe economic downturn in major developed markets, default rates should not significantly deviate from current levels and spreads will compensate for potential default risks. With respect to curve positioning, we are allocating our fixed income investments to intermediate maturities in all our reference currency portfolios. This implies a slightly higher duration for the EUR and the Swiss-franc portfolios, as the respective yield curve is relatively steep and offers much more attractive returns than short-term bonds. In addition, this positioning will benefit from the respective roll-down return as the bonds continue to mature. In the USD portfolios, duration is shorter than in the EU and Swiss franc portfolios given the inversion of the US yield curve between 10-year and 2-year bonds. Shorter maturities are more attractive than longer-dated bonds and less sensitive to interest rates than longer-term bonds, but overall, we are staying with a neutral duration.

We are also keeping our overweight allocation to gold. Gold has proven a solid portfolio diversifier during time of economic stress. If our basic scenario gets challenged by rising volatility, gold should help us stabilize the overall returns of our portfolios.

With respect to currencies, we like the Norwegian krona (NOK) and the Swedish krona (SEK). An improving European outlook in the medium term is likely to be a tailwind for NOK too, and we continue to pencil in strength for this currency over the year.

We are also maintaining an overweight allocation to the SEK. The SEK has cheapened significantly in the recent past and inflation has risen strongly, even as core inflation (excluding energy) remains close to 2%. Nevertheless, the Riksbank – the Swedish central bank – is worried about the sharp rise in inflation expectations. In recent months, inflation expectations moved from around 2% at the beginning of 2022 to over 4% in the middle of the summer. In addition, according to the Riksbank GDP is growing fast and far above potential growth, adding further inflationary pressure to the SEK. Strong economic growth and rising inflation in Sweden have fueled further expectations that the Swedish central bank will soon begin to reduce its balance sheet.

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