NEWSLETTER

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"Forced stop, mechanical recovery and accelerating inflation"

Figures released in May on the whole confirmed the ongoing economic recovery. PMIs validated the strong upturn in the US, in particular in services, where social distancing restrictions are being gradually lifted. In the euro zone, the services PMI has begun to take off and is now at a three-year high. The main inflation indicators rose faster than expected, driven by reopenings, higher energy prices and some supply chain issues. Federal Reserve officials have taken a wait-and-see attitude, arguing that the current acceleration is only temporary. And, lastly, the month's third major theme was regulation, with stricter supervision, particularly of large Chinese tech companies and crypto-assets.

Market trends

Driven by progress on the vaccination front, solid economic figures and central bank support, global equities continued to rise in May, gaining +1.6%. US equities (S&P 500 +0.7% and Russell 2000 +0.2%) underperformed the rest of the world (Stoxx 600 +2.6%, MSCI EM +2.3%, MSCI Japan +1.6%). Most US cyclical sectors (energy +5.8%, materials +5.2%, financials +4.8% and industrials +3.1%) outperformed techs (-0.9%, Nasdaq -1.4%) and consumer discretionaries (-3.8%). With the stabilisation of nominal interest rates (US 10Y -3 bps to 1.59%), higher inflation expectations (the US 10Y inflation break-even reached 2.56% in mid-May) and the depreciation in the US dollar (DXY -1.6%, EUR/USD +1.7% to 1.2228), gold was the best performing asset class last month (+7.8%), clawing back its year-to-date losses. Commodities rose by +2.7% (including WTI +4.3% and copper +4.4%) and listed real estate, +1.8%.

In Switzerland, the LPP pension fund indices (indices de la prévoyance professionnelle) improved in May by +0.2% for the LPP25+ and by +0.4% for the LPP40+, bringing their year-to-date performances to 2.4% and 5.2%, respectively.

Market performance as of 31 May 2021

STOCKS MARKETS	LEVEL 31.05.2021	CHANGE SINCE 30.04.2021	CHANGE SINCE 31.12.2020
Index			
MSCI World	711.5	1.56%	10.84%
USA			
Dow Jones Ind	34529.5	2.21%	13.76%
S&P 500	4204.1	0.70%	12.62%
Nasdaq Comp	13748.7	-1.44%	6.98%
Europe			
Euro Stoxx 50	446.8	2.59%	13.46%
SPI (Switzerland)	14669.0	3.45%	10.06%
CAC 40 (France)	6447.2	3.71%	17.56%
DAX (Germany)	15421.1	1.88%	12.41%
FTSE 100 (UK)	7022.6	1.08%	10.43%
Japan + Emerging			
Nikkei 225	28860.1	0.16%	5.71%
CSI 300 (China)	5331.6	4.16%	2.50%
MOEX Index (Russia)	3721.6	6.71%	15.01%
S&P BSE Sensex (India)	51937.4	6.68%	9.18%
Ibovespa (Brazil)	126215.7	6.16%	6.05%

BONDS & ALTERNATIVES MARKETS	LEVEL 31.05.2021	CHANGE SINCE 30.04.2021	CHANGE SINCE 31.12.2020
Rates			
Germany 10 y	-0.19	2 Bps	38 Bps
France 10 y	0.17	1 Bps	51 Bps
Italy 10 y	0.91	1 Bps	37 Bps
US 10 y	1.59	-3 Bps	68 Bps
Debt			
Investment Grade US	337.94	0.74%	-1.58%
Investment Grade Europe	264.08	-0.14%	-0.80%
High Yield US	2390.58	0.30%	2.25%
High Yield Europe	432.51	0.33%	2.93%
Emerging Debt	916.20	1.08%	-1.87%
Currencies			
EUR/USD	1.22	1.72%	0.09%
EUR/CHF	1.10	0.11%	1.65%
USD/CHF	0.90	-1.56%	1.55%
Commodities			
Crude Oil (WTI)	66.32	4.31%	36.69%
Gold	1906.87	7.79%	0.45%

Economic highlights

Pandemic situation

Waves of new infections are tracking the lack of progress in vaccinations geographically. English-speaking and Middle Eastern countries are ahead; Europe is in the middle of the pack (35% to 45% of its population has received at least one dose), and Asia and South America are bringing up the rear (in India, only 13% of the population has received at least one dose).

As a result, the pandemic has receded considerably in the US, with the number of reported cases falling more than 15-fold since peaking in mid-January, followed by Europe, where cases have fallen by almost six-fold. **Switzerland has fallen back below 1000 new daily cases, a level it had not reached since October. These declines have encouraged governments to ease social distancing measures.**

The Covid-19 front lines have moved back to Asia, where countries previously considered safe are facing a resurgence. Japan has extended its state of emergency in large cities in a last-ditch effort to avoid cancelling the Olympic Games, and India is still being overwhelmed by the pandemic, although even there the numbers of cases and deaths have begun to decline.

After the extension of vaccinations to a very large number of people in developed economies, the challenge now is to remove vaccine patents, with the hope of easing supply bottlenecks in the poorest countries. The US and China say they are open to discussion, while Europe is more hesitant.

Economic environment

PMI indices for May reflect the robust global economic recovery, driven by reopenings and pent-up consumption. Most notably, the business surveys confirm a strong recovery in services, where social distancing measures are gradually being lifted. For example, the US services PMI reached 70.1, an all-time high since the statistic has existed. On a seasonally adjusted basis, the composite reached 68.1 in May, up from 63.5 in April. The rate of increase was unprecedent and came on top of the previous record set in April. Note that the increase in new orders accelerated for the fifth consecutive month. The decline in retail sales is not a matter of concern. **However, job creations were surprisingly low, at 266,000 in April, instead of the 1 million forecast, and 559,000 in May, rather than 650,000**.

Signals from China point to some slack in the domestic economy for two reasons: 1/ China was the first to reopen and is therefore ahead in this cycle; and 2/ the authorities are trying to slow the flow of credit into the economy to rein in financial risk.

In the euro zone, the services PMI began to rise, moving from 50.5 to 55.1, a three-year high**. This points to a continued rise in the European PMI in the coming months if the reopening process is not disrupted.** The foundation of growth appears to have been laid, as, unlike in 2009, fiscal policies are more generous and the European Commission is planning its first bond issue to fund its 750 billion euro recovery plan.

As for Switzerland, the KOF economic barometer is pointing to some highly encouraging prospects, at a new record high of 143.2 vs. 136.0 forecast. **The resurgence in optimism is being driven mainly on the manufacturing sector and foreign demand. In the medium term, the export economy will benefit from European and US infrastructure plans.** The breakdown of the framework agreement with the European Union is likely to have few short-term repercussions, as existing relationships will remain in place. That said, the EU is no longer inclined to open or rescale bilateral agreements, which provide the sole entry point into the European Economic Area.

The inflation story

In our most recent newsletter, we had dealt with the fiscal stimulus issue, while focusing on the amount of expenses committed by the Biden administration to restart the US economy. The total amount, which is estimated at 9,200 billion dollars, raises fears that the bump in inflation seen in April will last longer than the Federal Reserve expects**. Driven by domestic demand, higher energy prices and some supply bottlenecks, the main inflation indicators have indeed risen at a faster pace than expected.** The US CPI hit 0.8% in April. Prices had risen by 4.2% on a year-on-year basis, a 13-year high, and by 3.0% in the case of core inflation, which excludes food and energy prices. In light of these figures, we will report back on inflation in two series of publications.

Why has inflation been so moderate and even weak over the past 20 years? The introduction of inflation targeting has done much to keep prices stable in industrialised countries and to smooth over their economic cycles.

Structural forces coupled with cyclical brakes have kept consumer prices from rising very much. Globalisation and free trade, the ageing population, the accumulation of debt, excess credit, and technological progress have had clearly deflationary effects. Temporary factors such as a series of crises and fiscal austerity after the Great Financial Crisis, precautionary savings during the Covid-19 pandemic, and job and health uncertainties have also kept inflation in check.

Inflation has been transformed from a "monetary" phenomenon into a "financial" one. Despite extremely favourable monetary policies over the past decade (central bank balance sheets have expanded six-fold on average since 2008), inflation has stayed low. The expansion of money supply has not encouraged end-consumers to spend more or businesses to invest more in their production facilities. What these expansive policies have done is contribute to asset inflation and, from this point of view, have helped restore confidence through a wealth effect, at least in part.

We see three broad categories of price increases in the recent statistics: 1/ one-off increases in used vehicles (which have risen by 10% month-on-month and by 21% year-on-year), due to a shortage of semiconductors for new cars and the use of private cars for pandemic protection; 2/ price increases that are, in fact, reversions to the mean after last year's drops, for example in the leisure sector (plane tickets +10% and hotel rooms +8.8% on the month). Prices in this category are likely to continue rising with the reopening of the economy as they have not yet reverted to pre-crisis levels; and 3/ other consumer prices that have remained rather stable and at their averages.

Inflation-boosting shortages of goods have resulted in extremely low inventory to sales ratios, particularly in retailing. As supply chain issues fade and as global trade returns to normal, these ratios should return to their pre-recession levels. **We expect this impact to be transitional, but in the meantime, higher costs may be passed on to consumers and thus show up in inflation figures.**

We find housing services especially instructive, as they make up at least one third of the CPI basket. They rose by just 2.1% year-on-year in April and have not yet returned to their 3.2% pre-crisis level**. In light of the double-digit annual increase in real-estate prices, we expect housing to be a source of inflationary pressure in the coming months.**

We see two major changes in the political environment since the recession: the Federal Reserve has modified its monetary framework by adopting an average inflation targeting, while fiscal policies have suddenly eased. As a result, public spending has become an essential tool of economic policy (even in Germany, which helped put through the 750 billion euro European recovery plan). Central banks, meanwhile, have been forced to play along by buying up public debt in order to keep bond yields very low and under control.

In 2020, we called central banks' unprecedented money injections a "monetary flood". These had been designed to help markets and economies recover from the Covid-19 recession. Coordination between governments and central banks had to be strengthened during the pandemic, as monetary authorities were powerless in helping businesses that forced to close and as interest rates were close to zero or even negative. **In our view, the tipping point in governments' post-crisis role was reached after Joe Biden's nomination for US president and the Democrats' de facto majority control of the Senate.**

The most striking thing about the new US administration policies are the sheer amounts involved: a total of 9,200 billion in spending (including 4,100 billion spread out over several years), which aims to support the US recovery. The 2010-2020 monetary flood has now given way to "fiscal overflow" and, with it, a potential boost to demand in an economy in which supply remains tight in some sectors.

According to the US Federal Reserve, this surge in inflation will be temporary. Jerome Powell is seeking to reassure the markets and to anchor inflation expectations, but what about the longer term? Key takeaways from recent central bank meetings suggest the era of loose money is not ready to end in either Europe or Japan, despite higher growth and inflation forecasts, but that the well is drying up in Canada and the United Kingdom, the first countries to announce a tapering in bond purchases. **In the current environment, we expect the first announcement of tapering in asset purchases to be made between Jackson Hole in August and the November meeting.** This would be a few months before the actual reduction in asset purchases of 10 billion dollars monthly between January 2022 and December 2022, allowing the Fed to begin raising its key rates as early as the start of 2023.

Next month, we will address the matter of whether this increase in inflation is indeed temporary and will review its impact on prices in various asset classes.

Investment decisions

In the current environment, we recommend exposing portfolios to global listed real estate investment trusts (REITs). Our investment thesis is based on a positive correlation between the performances of global listed real estate and the rise in long-term inflation expectations. This is driven by the updating of leases that often contain fixed or inflation-linked increases, for example in apartment and commercial leases. The sector has reacted rather well to higher interest rates, with limited price increases over 12-month time horizons.

Compared to sectors that have stalled in reaction to higher inflation expectations, REITs have an attractive profile, as seen in their year-to-date performances (+15.1% for the FTSE EPRA Nareit in developed countries, in dollars). Meanwhile, the relative lag accumulated over the past five years vs. to the major indices points to some upside potential in the event that investors react to higher inflation by modifying their sector allocations.

We are confident that this upside potential is real, especially as the sector is trading at a slight discount vs. its underlying properties. The best way to take on exposure to this theme is to do so via active selection, as growth expectations vary widely within the sector.

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