Cross-Asset Weekly

09 April 2021

Interest rates become less of a headwind for risk assets

Gold is the worst performing commodity and real estate one of the worst performing equity sectors since the beginning of the year – a period during which rising inflation expectations drove markets. That runs against the popular narrative that gold and real estate protect against higher inflation. This week, we explain that the relationship is a bit more complex. In addition to inflation expectations, real interest rates matter for real assets. These have risen in the first quarter and acted as a headwind to valuations for defensive assets. In this respect, Fed Chairman, Powell, had a reassuring message this week.

While acknowledging the stronger economic outlook, Jay Powell reminded investors yesterday – speaking on a virtual panel at the IMF and World Bank spring meetings – that the recovery remains uneven and incomplete. As Fed officials have stressed over the past few months, they now see full employment in a much broader and more inclusive way, with a focus on the most vulnerable parts of the workforce. And those are still facing extremely high jobless rates. In short, the Fed is still far from achieving "substantial further progress" towards its objectives of stable prices and full employment, which would allow it to consider tapering its asset purchases. Still, Mr. Powell offered investors a more precise numerical target for the improvement policymakers were looking for. The March employment report, with close to a million jobs created, has set the bar. Officials want "to see a string of ones like that, so we can really begin to show progress toward our goals". We conclude, that upside risks for bond yields remain in the medium term but that the interest rate market is more adequately priced for now.

Contacts

Dr. Karsten Junius, CFA
Chief Economist
karsten.junius@jsafrasarasin.com
+41 58 317 32 79

Raphael Olszyna-Marzys
International Economist
raphael.olszyna-marzys@jsafrasarasin.com
+41 58 317 32 69

Wolf von Rotberg
Equity Strategist
wolf.vonrotberg@jsafrasarasin.com
+41 58 317 30 20

Alex Rohner
Fixed Income Strategist
alex.rohner@jsafrasarasin.com
+41 58 317 32 24

Dr. Claudio Wewel
FX Strategist
claudio.wewel@jsafrasarasin.com
+41 58 317 32 26

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Investing in gold and real estate

Doing away with myths about inflation hedges

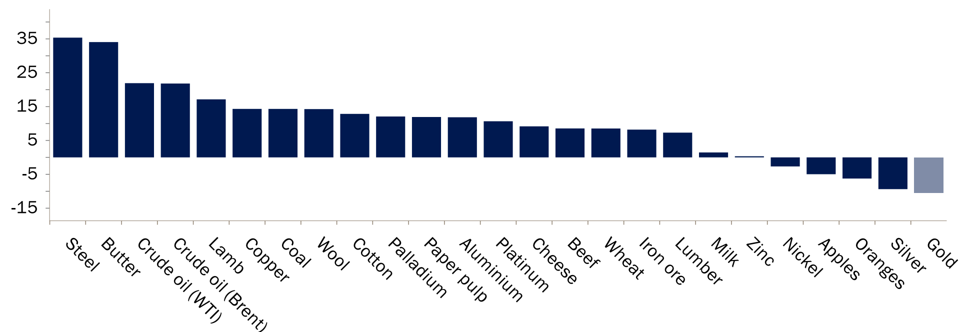
Dr. Karsten Junius, CFA
Chief Economist
karsten.junius@jsafrasarasin.com
+41 58 317 32 79

Real estate and gold are often said to be good hedges against higher inflation. This might be true in the long run if all else remains equal. But this rarely does. Higher inflation rates often lead to higher real interest rates to which both real estate and gold react very sensitively. We explain why.

Inflation rates and inflation expectations increased significantly in the first quarter

Worried that the massive expansion in central bank balance sheets over recent years might lead to a surge in inflation, many investors piled in so-called real assets, such as gold and real estate. Skyrocketing real estate prices and a surging value of gold seemed to prove them right. Just in the first quarter, as their worries have become mainstream and higher inflation is being priced into financial markets, something appears to be going wrong. The gold price has dropped by 15 % from its peak last year and is the worst performing commodity since the beginning of the year (Exhibit 1). Similarly, real estate is one of the worst performing sectors in the European equity market over the last three months. This is despite an improving perspective for commercial real estate that has been hit hard by the pandemic and is part of the segment besides residential real estate. Are real assets no hedge against inflation anymore? Or are they severely mispriced such that it is time to add to their exposure?

Exhibit 1: Gold performed worse than all other commodities this year



Source: Macrobond, Bank J. Safra Sarasin, 08.04.2021

Rents should increase with higher construction costs and higher incomes – both increase with higher inflation rates

Let's start with real estate. To be precise, this is not one market, but two – the rental market in which the price for the use of physical space is settled and the asset market in which the price of owning and renting it out is determined. Construction of new houses will only take place as long as landlords can recoup the cost of construction or renovation. As a result, asking rents and construction costs are positively correlated. As rents are paid out of income, higher wages make higher rents affordable. In turn, construction costs and nominal income increase with the general price level, which is why rents are correlated with inflation in the medium term.

Real estate is one of the very few equity sectors in which income margins fall with higher inflation as they usually go together with higher interest rates

Real estate assets, however, are usually not paid out of income. For their affordability, financing costs matter. This is also true for real estate companies which use significant leverage to finance their projects and thus benefit from low interest rates. As higher inflation rates lead to higher nominal interest rates, their input costs increase and their profit margins are being squeezed. If the rise in nominal interest rates is not only driven by higher inflation expectations, but also by higher real rates, the situation gets worse. While

inflation helps to lift revenues via higher rents, partly offsetting the deterioration in financing conditions, an increase in real rates drives up costs.

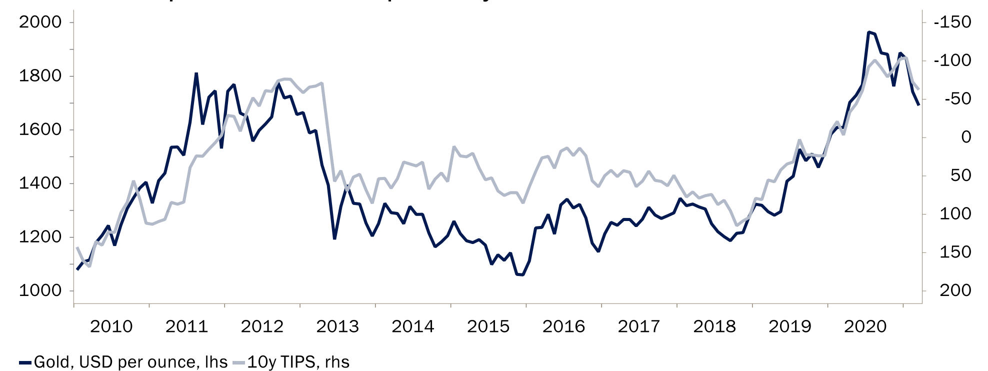
Real interest rates are used to discount the value of future dividends that real estate companies pay

Real rates also need to be considered when investing into the equity of real estate companies. As equity holders participate in the future earnings of a company, stock prices can theoretically be explained by the discounted value of all future dividends, with real yields serving as the discount rate. Those increased in the first quarter, together with the expectation that higher future policy rates are compatible with inflation at its target level. Hence, the net income of real estate companies not only falls with higher interest rates, but the current value of future income is also lower. No surprise that their stocks do that badly.

Gold prices fall if the return on other relatively safe assets increases

A similar rationale holds for gold. In the long-term, physical supply and demand should move with the general price level as it determines the costs of gold exploration and mining as well as the affordability of gold based products like jewellery. All else equal, gold prices would indeed increase with inflation, keeping constant its purchasing power. This is why savers in fragile economies often invest in gold when loosing trust in their domestic currency. In more developed economies, however, a wider range of relatively safe assets are available such that their return potential becomes a decisive factor. This is the disadvantage of holding gold as it doesn't earn any income. If other assets with a safe and stable long-term income, such as government bonds, see their real yields (TIPS) increase, gold becomes relatively less attractive to own, and prices fall (Exhibit 2).

Exhibit 2: Gold prices can be best explained by fluctuations of real interest rates



Source: Macrobond, Bank J. Safra Sarasin, 08.04.2021

Gold and real estate are not materially mispriced right now as their underperformance can be well explained by the higher real interest rates

Hence, gold and real estate can only be expected to move parallel to inflation if real interest rates remain constant. In the past decade this was not the case as real rates fell sharply driving up gold and real estate prices (Exhibit 2). In the current decade this is probably not the case either. If fiscal policies in the US and other countries continue their expansionary path and the global economic recovery continues in 2022, increasing real rates are likely a headwind for real assets for some time. That said we also have the view that the worst and the fastest rate increase is behind us for this year. Both the Fed and the ECB are trying to limit the increase of bond yields by holding policy rates constant and continuing their bond purchases. This means that headwinds from increasing rates for real assets will prevail but they are blowing less forcefully in the coming months than in the previous ones. On the positive side, it is clear that rental incomes will grow more easily once the economies open up from their pandemic related lock-downs.

US Fixed Income

It's all about the Fed's perceived reaction function

Alex Rohner
Fixed Income Strategist
alex.rohner@jsafrasarasin.com
+41 58 317 32 24

With the increase in cumulative tightening expectations since the start of the year, the Treasury market has made significant headway towards a more adequate pricing. While upside risks remain in the medium term, upward pressure on yields should wane over coming months along with a moderation in the manufacturing sector.

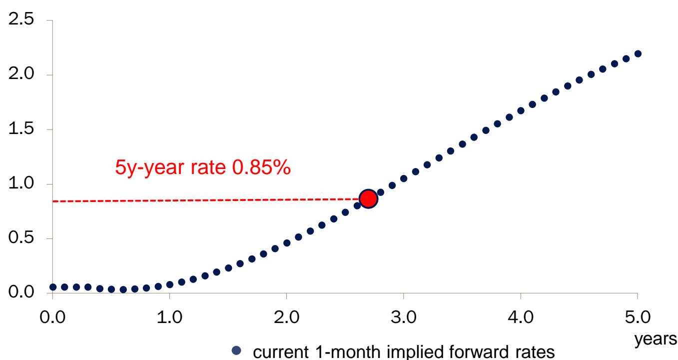
Expectations for short-term rates drive the level of bond yields

There is a straightforward link between absolute yield levels and implied short-term rates. Yields for a given maturity are equivalent to a succession of (say 1-month) forward rates that yield an identical return over the maturity of the bond. A 5-year yield is nothing else than the geometric mean of the implied short-term rates over the next five years. Therefore, they also incorporate current market expectations for the path of short term rates. Any changes in expectations will shift points on the yield curve up or down. (Exhibit 1).

Bond yields are a function of expected Fed policy plus a risk premium

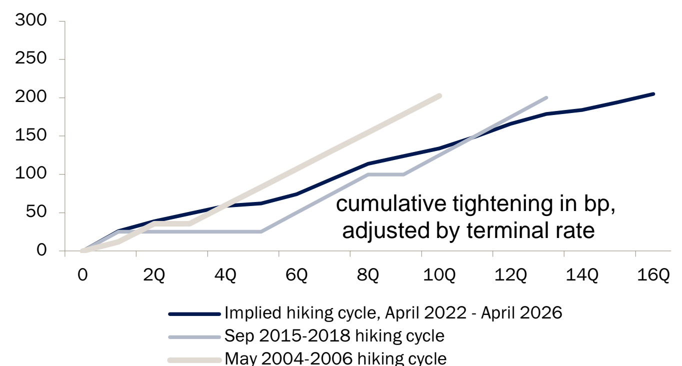
While implied forwards are mainly a function of perceived Fed policy, they also contain a risk premium, commonly described as term premium. It becomes higher as we move out on the maturity spectrum since it is primarily a compensation for the (interest rate) risk of holding longer term bonds. In the terminology of implied forward rates, it captures the risk of unexpected deviations from a 'normal' path of short term rates because of (1) the central bank's policy shifts due to an unexpected rise in inflation or (2) a meaningful change in demand and supply dynamics in the bond market. Both risk factors are currently hotly debated in terms of a possible inflation overshoot and the timeline and extent of the taper of asset purchases. Accordingly, the term premium has increased and it must therefore not come as a surprise that markets are pricing more than the Fed has said it will deliver.

Exhibit 1: A 5-year yield is a geometric mean of implied forwards



Source: Bloomberg, Bank J. Safra Sarasin, 09.04.2021

Exhibit 2: The market prices a relatively smooth rate hike cycle



Source: Bloomberg, Bank J. Safra Sarasin, 09.04.2021

The market is more adequately priced, but upside risks remain

The current implied pace of cumulative rate hikes resembles the most recent hiking cycle of 2015 to 2018. The implied path is still relatively flat compared to previous cycles, and it is probably overly smooth as markets tend to price an acceleration in the pace of expected rate hikes once we move closer to a potential lift-off in policy rates (Exhibit 2). Consequently, there are still upside risks to our rate view in the medium term. For now, the Fed will likely be patient and we note that with the significant increase in cumulative tightening expectations since the start of the year and the concomitant rise in bond yields, the Treasury market has come a long way towards a more adequate pricing. We therefore expect the upward pressure in yields to wane over coming months along with a moderation in the momentum of the manufacturing sector.

Economic Calendar

Week of 12/04 – 16/04/2021

Country	Time	Item	Date	Unit	Consensus Forecast	Prev.
Monday, 12.04.2021						
Tuesday, 13.04.2021						
UK	08:00	Industrial Production MoM	Mar	mom	--	-1.50%
	08:00	Industrial Production YoY	Mar	yoy	--	-4.90%
GE	11:00	ZEW Survey Expectations	Apr	Index	79.00	76.70
US	12:00	NFIB Small Business Optimism	Mar	Index	98.00	95.80
	14:30	CPI Ex Food an Energy MoM	Mar	mom	0.20%	0.10%
	14:30	CPI Ex Food an Energy YoY	Mar	yoy	1.60%	1.30%
Wednesday, 14.04.2021						
US	20:00	US Federal Reserve Beige Book				
Thursday, 15.04.2021						
GE	08:00	CPI EU Harmonized MoM	Mar	mom	--	0.50%
	08:00	CPI EU Harmonized YoY	Mar	yoy	--	2.00%
US	14:30	Initial Jobless Claims	Apr10	1'000	--	744k
	14:30	Retail Sales Control Group	Mar	mom	5.50%	-3.50%
	14:30	Philly Fed Business Outlook	Apr10	Index	40.00	51.80
	15:15	Capacity Utilisation	Mar	%	0.76	0.74
	16:00	NAHB Housing Market Index	Apr10	Index	84.00	82.00
Friday, 16.04.2021						
EU	11:00	CPI MoM	Mar F	mom	--	0.90%
	11:00	CPI YoY	Mar F	yoy	--	0.90%
US	14:30	Building Permits	Mar	Index	1745k	1682k
	16:00	Housing Starts	Mar	Index	1615k	1421k
	16:00	U. of Michigan Sentiment	Apr P	Index	89.00	84.90
	16:00	U. of Michigan Expectations	Apr P	Index	--	79.70

Source: Bloomberg, J. Safra Sarasin as of 09.04.2021

Market Performance

Global Markets in Local Currencies

Government Bonds	Current value	Δ 1W	Δ YTD	TR YTD in %
Swiss Eidgenosse 10 year (%)	-0.29	2	26	-1.5
German Bund 10 year (%)	-0.33	0	24	-1.5
UK Gilt 10 year (%)	0.75	-5	54	-4.2
US Treasury 10 year (%)	1.65	-7	73	-4.9
French OAT - Bund, spread (bp)	26	1	2	
Italian BTP - Bund, spread (bp)	101	5	-10	

Stock Markets	Level	P/E ratio	1W TR in %	TR YTD in %
SMI - Switzerland	11'207	18.9	0.8	6.2
DAX - Germany	15'203	16.7	1.3	10.8
MSCI Italy	785	14.3	-0.5	9.8
IBEX - Spain	8'638	19.5	0.5	7.4
DJ Euro Stoxx 50 - Eurozone	3'978	19.2	1.4	12.6
MSCI UK	1'947	14.4	3.1	8.9
S&P 500 - USA	4'097	23.5	3.2	9.5
Nasdaq 100 - USA	13'759	30.0	5.1	7.0
MSCI Emerging Markets	1'343	15.4	0.6	4.3

Forex - Crossrates	Level	3M implied volatility	1W in %	YTD in %
USD-CHF	0.93	6.6	-1.7	5.1
EUR-CHF	1.10	4.5	-0.7	1.5
GBP-CHF	1.27	7.6	-2.7	5.6
EUR-USD	1.19	5.9	1.1	-3.3
GBP-USD	1.37	7.6	-1.0	0.5
USD-JPY	109.5	6.3	-1.1	6.1
EUR-GBP	0.87	6.5	2.1	-3.8
EUR-SEK	10.19	5.6	-0.7	1.1
EUR-NOK	10.09	8.5	0.6	-3.9

Commodities	Level	3M realised volatility	1W in %	YTD in %
Bloomberg Commodity Index	84	15.4	0.8	8.4
Brent crude oil - USD / barrel	63	49.8	-2.2	23.1
Gold bullion - USD / Troy ounce	1'748	13.8	1.1	-7.7

Source: J. Safra Sarasin, Bloomberg as of 09.04.2021

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Bank J. Safra Sarasin Ltd
Alfred-Escher-Strasse 50
P.O. Box
CH-8022 Zürich
T: +41 (0)58 317 33 33
F: +41 (0)58 317 33 00
www.jsafrasarasin.com

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