J. SAFRA SARASIN
SUSTAINABLE ASSET MANAGEMENT

CIO Update

Investment Committee Bank J. Safra Sarasin
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What if inflation is not transitory?

Inflation remains the dominant theme in financial markets. Emerging price pressure can already be observed in many segments. But is this sustainable?

Macro outlook – Inflation about to make a comeback?
Inflation data have risen more strongly than expected in recent weeks. Not only in the US, but also in the euro zone, the year-on-year inflation rate of 2% recently exceeded market participants' expectations. As in previous months, the strongest contribution came from rising energy prices. At the same time, the surveys also add to the evidence that near-term price pressures are intensifying. Delivery times lengthened at a record pace consistent with widespread reports of input shortages. Companies met the strong demand by running down their inventories. Input and output prices also rose at a record pace in this environment. Against this background, the risk of sharply rising inflation rates appears increased. However, this has not weighed on consumer confidence – especially not in the euro zone, where it has already overtaken the US. The latest easing measures are therefore having a positive effect.

A similar picture is painted by the European purchasing managers' indices, which, following already strong April figures, continued their positive momentum in May and again exceeded expectations. Against the backdrop of a gradual re-opening of the economy, the services component rose to 55.2 points, a three-year high. The purchasing managers' index for the manufacturing sector climbed to 63.1 points – the highest value since the start of the data series.

Although there is still some catching up to do in some regions of the world, first signs of growth fatigue are already becoming apparent, for example in the form of a slowdown in the positive momentum of new orders.

Sharp rise in US inflation data

Source: Refinitiv, Bank J. Safra Sarasin, monthly data, June 2000 to June 2021

Editorial

Dear Reader

Financial markets have performed well this year. While rising stock prices surprised many investors last year, they are in line with positive economic growth this year. The pandemic seems to be more or less behind us and there are only a few clouds on the horizon. One risk that should not be ignored, however, is inflation. Whether the US Federal Reserve is right and high inflation is only transitory, we will probably not see until the end of the year at the earliest. Until then, inflation rates are likely to increase further and remain high. If the central bank does not react and interest rates rise sharply, it could lead to a sell-off on the stock market. It is therefore important to reduce risk compared to the beginning of the year and keep a close eye on portfolio risks overall.

Philipp E. Bärtschi, CFA, Chief Investment Officer

Bonds – Yields trapped in narrow range

Global central banks persistently point to transitory effects as being responsible for the sharp rise in inflation rates. Of course, base and one-off effects (e.g., an oil price rally that should not last and pandemic-related supply chain disruptions) are easy to argue with. But concerns about a permanent rise in inflation are nevertheless not unfounded. Central banks are willing to keep the economy running hot, and further fiscal policy measures are on the way. It is true that the consistent communication policy of the US Federal Reserve has so far managed to prevent a sustained rise in yields in the US government bond markets – ten-year US Treasuries are still trading below 1.6%. However, an unchanged positive economic environment, further fiscal measures and increasing inflationary pressure are unlikely to leave the bond markets unscathed and free government bond yields from their lethargy.

Ten-year US Treasury yields: Calm before the storm?

Source: Refinitiv, Bank J. Safra Sarasin, daily data, 1.1.2019 to 9.6.2021

Equities – Improving environment for emerging markets

The main concern for equity markets is that higher than expected inflation could lead to an earlier tightening of global monetary policy and rising yields. Financial markets are therefore still looking for direction, and investors have recently responded to this uncertainty with a focus on quality as well as value and dividend stocks. In terms of regions, according to the latest Bank of America fund manager survey, investors are most overweight in European equities, as this is where the greatest catch-up potential exists, and not only on an economic level. This is also reflected in the more stable price behavior in recent weeks. What most regions have in common is the weaker performance of growth stocks, not only due to rising interest rates, but also due to stronger earnings performance of cyclical sectors. And the European stock market in particular has benefited from this recently.

Meanwhile, after a weak start to the year, the environment for emerging market equities is also improving, largely due to the stabilization of Chinese credit growth. The PBoC had focused on China's debt problems in recent months and provided only limited stimulus – credit growth was strongly negative. The declining credit impulse weighed heavily on the emerging market equity complex, but a bottom seems to have formed recently.

Asset Allocation – Slight overweight in equities

We are currently in a transition process from the strong recovery in the aftermath of the COVID 19 recession to a sustained expansion characterized by also positive but less strong growth rates. These transitions, which vary from region to region, are characterized by increased uncertainty. Temporary setbacks are possible at any time, but overall risk assets remain well supported. Sentiment indicators and macro data are at high levels, companies are ready to invest, consumers are ready to consume, and liquidity is not likely to be withdrawn from the market any time soon. However, much is already priced into current market levels, so upside potential is limited. We prefer European equity markets, which should benefit more from the continued reflation of the economy, not least due to attractive valuations. In emerging market equities, we still see catch-up potential due to the bottoming out in China and are increasing our allocation to an overweight. Overall, we are now slightly overweight equities.

We are keeping our underweight in government and investment grade bonds. We expect interest rates to rise slightly due to rising inflation rates in the context of a continued economic recovery, which is likely to weigh particularly on investment grade bonds, whose credit spreads have tightened sharply in recent months and offer an unfavourable risk-return profile. Uncertainty regarding a change in the monetary policy path of global central banks or the start of a corresponding change in communication in late summer is leading to latent uncertainty in the bond market. Against this backdrop, we prefer carry instruments such as high-yield bonds and emerging market bonds, which offer a more attractive return behaviour, especially in an environment of above-average and rising inflation rates. We remain overweight in both segments.

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Attractiveness of individual investments

Asset class	Weighting	Relative attractiveness within the categories			
Equities	= / +	Developed markets =	Emerging markets +	Large caps =	Small caps =
Bonds	–	Government bonds – –	Corporate bonds – –	High-yield bonds +	Emerging markets +
Alternative assets	= / +	Money market +	Convertible bonds –	Other alternatives +	Real Estate =

Source: J. Safra Sarasin

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