MAERKI BAUMANN & CO. AG

PRIVATBANK

Inflation – an update

Market Comment, July 2022

Some time ago, we already reported on various global inflation trends in one of our market commentaries. In the meantime, the central banks have responded to the persistently high level of consumer price inflation and adopted a new monetary stance. There is no certainty that this move will be enough to bring about a substantial decline in inflation, particularly in the US. Should the desired results not be achieved, the US Federal Reserve (Fed) may consider becoming more aggressive in its efforts to reduce economic demand and introduce a more restrictive monetary policy. This would result in more volatile financial markets. When it comes to investing, a focus on quality will remain particularly important this year.

Since the fourth quarter of 2021, consumer price inflation as measured by headline inflation has reached historically high levels in many countries, with this being especially true in the US. However, the situation in terms of inflation is not yet as extreme as that seen in the 1970s. What is the source of this acceleration in inflation?

More expensive commodities, and historically high energy prices in particular, are the main driver of this spike in inflation. This is related to the demand for oil, gas, industrial metals and agricultural commodities, which has exceeded the level seen prior to the coronavirus pandemic. This high demand has come at the same time as an inadequate supply of raw materials, especially oil and gas, with the situation being accentuated by Russia's attack on Ukraine and Western sanctions against Russia. A further factor is the previous low level of investment in oil production over a period of many years. As a result, current reserve capacities in crude oil production are at a historically very low level. When viewed over a period of many years, inventories of important commodities such as crude oil, natural gas, aluminium and copper are also very low at present. For this reason, higher prices are often being paid for deliveries of raw materials in the next month, as partly needed for industrial production, than is the case for raw materials with a delivery time of a year. Historically speaking, this is an extremely rare occurrence on the commodity markets and is referred to as "backwardation".

Global supply problems, especially in China, with its strict coronavirus policy, but also in other Asian countries, should be mentioned as a further driver of inflation. The increase in demand for consumer goods since the various coronavirus waves can be explained by spending on services such as concerts and travel, which were almost impossible to enjoy during the various phases of the pandemic. Due to limited production possibilities, rising prices are being seen for goods in particularly high demand, including tablets, computers, smartphones, other electronic devices and cars. This is not only due to the limited production scope, but also due to higher raw material prices during the manufacturing process. Inflation in goods whose prices had generally been heading downwards in recent decades due to oversupply has thus increased significantly in recent months viewed year on year, particularly in the US.

> "If US monetary policy becomes even more restrictive, further distortions are possible, especially in the case of equities with high interest rate sensitivity."
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> Gérard Piasko, Chief Investment Officer

Transport costs have also risen due to the excessive strain placed on cargo ports. The hope that goods inflation will reduce somewhat in the medium term seems possible. It is quite conceivable that prices for services, such as those currently seen in the tourism sector, will remain relatively high in the face of higher demand. More expensive prices for travel and sporting events should not really come as a surprise. Inflation may therefore fall less than hoped by the central banks over the coming months or even rise further.

In the US, inflation is also driven by rising wages, high property prices and higher rents. The Fed hopes that it will be able to bring historically high consumer prices down once more with interest rate hikes and a reduction in its bond purchases. This is likely to prove very difficult, however, as given the increased savings of Americans (after all the cheques sent out by the US government in recent years), consumer demand is still high. Should the Fed come to the conclusion that a more aggressive decline in demand is needed, even greater volatility can be expected on the financial markets.

The financial markets have started to price in higher interest rates and thus financing costs. Recently, however, a contrary trend has emerged. In the event of an even more restrictive US monetary policy through a reduction in the Fed's balance sheet, there is nevertheless still a risk of an increase in interest rates and bond yields. Overall, this could also lead to a rise in financing costs for companies and further distortions on the equity market. This is especially possible in the case of the US-based Nasdaq index with its high share of growth stocks with a "long duration", i.e. stocks with high interest rate sensitivity and relatively expensive valuations.

Conclusion: We are therefore focussing on quality in our equity and corporate bond investments, i.e. on companies that are less sensitive to rising financing costs during phases of historically high inflation thanks to their good market position and relatively stable profitability and that are more shielded against economic risks thanks to their defensive orientation.

Gérard Piasko

Gérard Piasko is Chief Investment Officer and head of the investment committee of private bank Maerki Baumann. Before he was for many years Chief Investment Officer of Julius Baer, Sal. Oppenheim and Deutsche Bank.

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