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Weekly Market Flash
The great inflation shock

November 14, 2021

This week was characterized by stellar inflation data in the US. The truth is that despite this bombastic data, markets managed to remain unchanged overall. It is clear that the main element of support for markets, and in particular for growth sectors, lies in the level of real rates in the short term, but also in the long and very long term – which have reached historic lows under every type of measurement. In fact, real rates between 5 and 30 years in the US are crushed in negative territory, between -1.5% and -0.5%! In our view, the level of real rates signals that we are in fact in a non-explicit, or "soft", form of financial repression.

Highlights

- Headline inflation came out at +0.9% month-on-month, and +6.2% year-on-year, the highest since 1990. Core was +0.6% month-on-month and +4.3% year-on-year.
- With current Fed Funds at 0.25%, the market expects little more than two rate increases for the whole of 2022, which would bring the terminal rate to around the 1% area.
- US stocks pulled back from record highs on inflation worries, while major European markets managed to close in the green. Meanwhile, Chinese equities advanced on the back of speculation that the government would declare easing measures to support the troubled real estate sector.
- In fixed income markets, while 5-year breakeven inflation reached another fresh high, there is embedded belief that a few rate hikes in a year or two will be sufficient to eradicate the inflation problem and bring things back to normal.
- The price of gold finally breached the long-held downside trendline from the July highs of last year.

"The Fed's resistance to changing rates in a context of now rampant inflation is pushing Fed Funds in real terms into extremely negative territory. The levels reached today exceed the negative record of the 1970s."

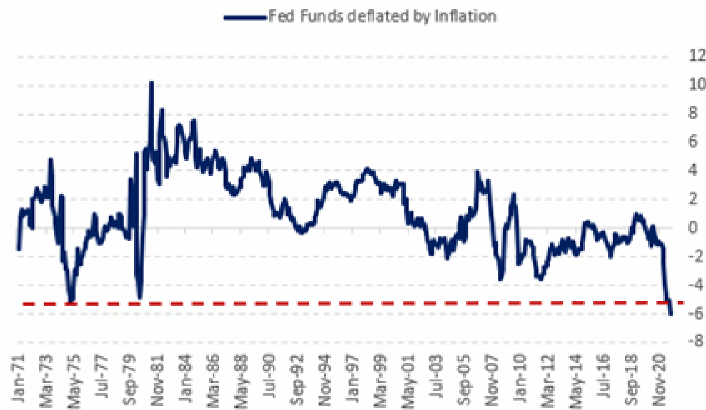
Markets & Macro | The great inflation shock

Riding out a complicated scenario.

Fed Funds expectations have certainly moved higher in recent weeks, but to an infinitesimal degree relative to the levels of realized inflation, which is unlikely to normalize over the coming months. With current Fed Funds at 0.25%, the market expects little more than two rate increases for the whole of 2022, which would bring the terminal rate to around the 1% area. However, this level seems totally inadequate with respect to current inflation levels, and one which risks, at this point, to start fueling consumer expectations. As we know, inflation expectations have already risen recently - and at this point, they risk becoming structural. This can have an impact on consumers' psychology when it comes to their spending decisions, which is challenging to fix.

The Federal Reserve's (Fed) resistance to changing rates in a context of now rampant inflation is pushing Fed Funds in real terms into extremely negative territory. As Figure 1 suggests, the levels reached today exceed the negative record of the 1970s.

Figure 1: Fed Funds Rate



Source: Bloomberg, as at November 12, 2021.

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Our view: Watching the release of the CPI numbers was terrifying. Headline inflation came out at +0.9% month-on-month, and +6.2% year-on-year, the highest since 1990. Core was +0.6% month-on-month and +4.3% year-on-year. The already impressive expectations were exceeded by a wide margin. This time, unlike previous months, it emerged that the temporary components made up only a reduced contribution, with increases well spread across categories, and a catch up by the rent component (as expected), following the abnormal rise in house prices during the pandemic (of around 30% over the last two years). What's more, all the surveys on pricing intentions by companies show no sign of abating.

At this point, it is really challenging to think that the situation can improve in the coming months – and this inevitably puts the Fed and other developed market central banks in serious difficulty, as they have continued to affirm the rhetoric of the transitory phenomenon. The principle of "preventive" monetary policy is now completely gone, all the more so if we consider that due to the base effects triggered by the reopening of the economies and the rise in energy prices, headline inflation should rise above 7% and core inflation above 5% in the coming months, before starting to fall.

The paradox is that it was President Biden and some Democratic politicians (including the moderate Manchin, whose vote is essential for the approval of the administration's social reform) who intervened in the debate on inflation, expressing concerns about the loss of purchasing power by average citizens. It is no coincidence, in fact, that in this context, the publication of the Michigan University's Consumer Confidence has disappointed expectations, with a further drop and now in crisis territory.

"We seek alternative positions in order to ride out a scenario that is becoming more complicated due to the rise in inflation in the presence of central banks, which risk losing at least part of their credibility."

The main beneficiary of the inflationary dynamics were precious metals, led by gold, which finally seems to have broken through resistance levels that had been limiting it for many months (Figure 2). In terms of asset allocation, it seems clear to us that equity markets are supported first and foremost by huge retail flows, which are completely disconnected from the prospects of the real economy. Also supporting the market are extremely favorable financial conditions, which are in turn supported by negative real rates and tight credit spreads, and corporate earnings expectations that remain positive for 2022 and 2023, with growth between 5% and 10% for both years. In our view, a TINA (there is no alternative) element brought to extremes seems to be at play. The more real yields collapse, the more equities are are attractive relative to bonds - even if valuations become unattractive and earnings or economic growth no longer offer a good reward.

Despite our cautious attitude, we do not intend to "fight" these dynamics with an overly defensive positioning of portfolios. We are therefore limiting ourselves to seek alternative positions in order to ride out a scenario that is becoming more complicated due to the rise in inflation in the presence of central banks, which risk losing at least part of their credibility. We therefore welcomed the upward breakout of gold, on which we have been positioned for months together with cryptocurrencies. We also opened a new short position on US Treasuries at the beginning of the week, as we waited for the inflation data. The negative surprise on inflation and two bad auctions on the 10 and 30-years during the week provided a favorable wind for our position, for the time being.

Chart of the week

After the US reported the hottest inflation print in three decades, the price of gold finally breached the

long-held downside trendline from the July highs of last year. The outlook for gold is constructive, and temporary price moves above USD1,900 an ounce are possible in the short term. Support: 1790/1835. Resistance: 1870/1900.

Figure 2: Price of Gold

Source: Bloomberg, as at November 12, 2021.

> "After the US reported the hottest inflation print in three decades, the price of gold finally breached the long-held downside trendline from the July highs of last year."

Equities | Breakups everywhere

Traditional businesses are evolving to stay competitive.

US stocks pulled back from record highs on inflation worries, post a strong CPI figure on Wednesday. On the other side, major European markets managed to close in the green. Meanwhile, Chinese equities, a major laggard year-to-date vis-à-vis other major equity markets, advanced on the back of speculation that the government would declare easing measures to support the troubled real estate sector.

Figure 3: Global Equity Market Performance

		Value	WTD % Chg	MTD % Chg	YTD % Chg
INDU Index	Dow Jones	36,100.31	-0.56%	0.86%	19.79%
SPX Index	S&P 500	4,682.85	-0.27%	1.75%	26.20%
CCMP Index	Nasdaq	15,860.96	-0.68%	2.38%	23.77%
SX5E Index	Euro Stoxx 50	4,370.33	0.17%	2.84%	26.04%
SMI Index	Swiss Market	12,516.05	1.58%	3.37%	20.27%
UKX Index	FTSE 100	7,347.91	0.72%	1.69%	17.48%
CAC Index	CAC 40	7,091.40	0.72%	3.82%	30.57%
DAX Index	DAX	16,094.07	0.25%	2.58%	17.31%
FTSEMIB Index	FTSE MIB	27,732.39	-0.23%	3.19%	27.87%
NKY Index	Nikkei 225	29,609.97	-0.01%	2.48%	9.52%
HSI Index	Hang Seng	25,327.97	1.88%	-0.47%	-4.61%
SHSZ300 Index	CSI 300	4,888.38	0.95%	-0.17%	-4.53%

Source: Bloomberg, as at November 12, 2021. Performance figures in indices' local currencies.

> "...we are witnessing a major evolution in how traditional businesses are opting to remain competitive in today's market."

JP Morgan upgraded the UK to overweight on the basis of a deep valuation discount to other major markets. Elsewhere across equity markets, the IPO of Rivian, the electric truck maker backed by Amazon and Ford, made history by becoming the largest for a US company since the IPO of Facebook. Rivian currently has a market cap of USD113.5 billion with no revenue! Rivian's market cap exceeds that of Daimler (USD107.7 billion), General Motors (USD92 billion) and Ford Motor (USD77.9 billion).

Our view: Two iconic conglomerates announced that they would breakup themselves up. General Electric stated that it would split into specialized companies. NCP model portfolio holding Johnson & Johnson also announced it would separate its consumer health business from its medical device and pharmaceutical businesses. While the reasons behind these companies' decisions are different, we are witnessing a major evolution in how traditional businesses are opting to remain competitive in today's market.

Of course this is not the first time we've seen conglomerates choose to breakup in order to unlock value. Recent calls we held with the senior management of industrial companies suggest that the c-suite is frustrated at valuation levels despite taking several steps to address shareholders' demands. We expect management teams to become more aggressive in addressing shareholders' concerns, especially as the discount to the fast growth (mostly technology) companies widens again. We welcome these value enhancing actions and expect the holding company discount of these conglomerates to vanish, thus narrowing the discount of value to growth over time.

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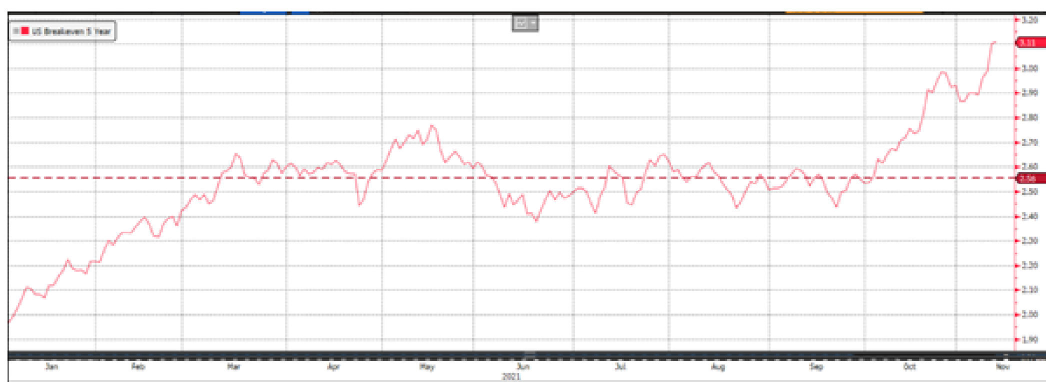
Fixed Income | Markets react well to inflation shock

Issuers rush to lock in cheap funding.

After Wednesday's CPI print, the bond market narrative and market pricing remained a bit disconnected. The narrative is that inflation is surging, the Fed has lost control, and that prices are becoming unstable. However, markets are pricing somewhat differently.

Figure 4: US 5-year Breakeven Inflation

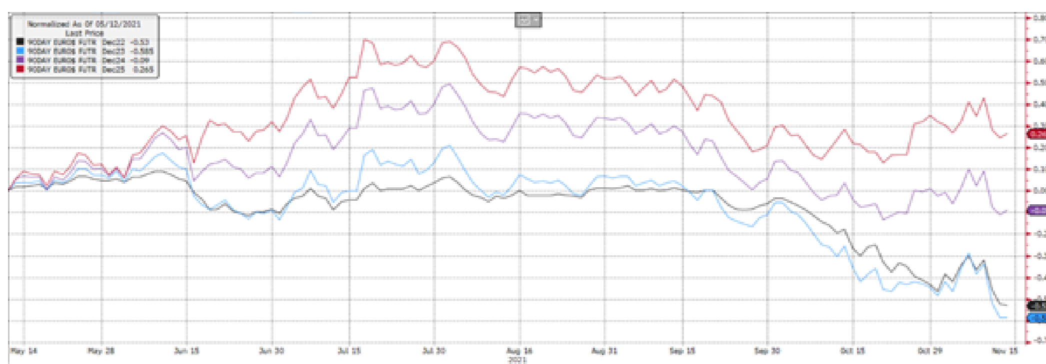


Source: Bloomberg, as at November 12, 2021.

> "...there is embedded belief that a few rate hikes in a year or two will be sufficient to eradicate the inflation problem and bring things back to normal."

While 5-year breakeven inflation reached another fresh high, there is embedded belief that a few rate hikes in a year or two will be sufficient to eradicate the inflation problem and bring things back to normal.

Figure 5: Eurodollar Futures



Source: Bloomberg, as at November 12, 2021.

Yields for 2024 and 2025 (purple and red lines) of the Eurodollar strip remain lower than they were six months ago (futures prices are higher, meaning lower rates.) Meanwhile, the December 2022 and 2023 (black and red lines) contracts are trading at a fresh low in price/fresh high in rates. In a nutshell, the market is pricing more Fed tightening in the relatively near future, but less overall.

Our view: Ultimately, this is one of the main reasons why the US Treasury curve hasn't moved higher in yields, particularly at the long end, in real terms. It is a very difficult to explain the driver behind this incredibly low negative real rates scenario. If there is "too much" savings and liquidity, it implies short-term rates will have to go much higher to tighten financial conditions. If there is a very low terminal rate, it

implies the upcoming slowing growth is closer than assumed. In short, until the market accepts the possibility that the long-run nominal funds rate is shifting higher, long-term yields may continue to remain low, leaving investors scratching their heads.

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In the primary market with the 10-year Treasury yield falling in recent weeks and credit spreads holding steady, borrowers saw a window to sell debt cheaply before yields rise again. US investment grade borrowers sold USD25 billion of new bonds this week. The US junk bond primary market pushed the 2021 volume to a record USD439 billion. Ford Motors issued the biggest green bond ever for a US company. The USD2.5 billion Ford inaugural green bond maturing in 2032 garnered a total book of USD8.6 billion, enabling a reduction in the coupon from an initially discussed 3.625% level to 3.25%)

In Europe, China came back to the market with a euro sovereign bond. Investors amassed orders for more than four times (EUR17 billion) combined of the three (0% 2024 at swap +0 bps versus +20 bps initially offered), seven (0,125% 2028 at swap +20 bps versus +40 bps) and 12-year (0,625% 2033 at swap +52 bps versus +65 bps). Finally, General Electric's plan to buy back a massive USD23 billion of bonds will exacerbate the technical imbalance between investors and investable assets, giving investors more cash to invest when there are relatively few securities to buy, and putting even more pressure on industrial credit spreads, which are already tight.

Week Ahead | Key events to watch for

- **In the US, retail sales, three regional Fed surveys** (NY Empire, Philly FED and Kansas City), housing starts/building permits and industrial production will be published.
- **In China, retail sales, industrial production,** fixed asset investment and the unemployment rate are due next week.
- **CPI figures will be released** in the UK and Canada.
- **In terms of central bank activity,** the spotlight will be on the Fed with a deluge of speakers spread out over the week. In Turkey, the CBRT with the monetary policy genius of Ankara will be ready to cut rates by another 100 bps.

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