

# House View

20.07.2021

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### Transitory or not

Markets have seemingly bought into the Fed's view that inflation will be 'transitory' seeing the recent spike in core inflation to 4.5% as merely the result of a re-opening economy, which will gradually fade in the coming quarters as activity begins to normalize. The plunge in longer-dated Treasury yields from above 1.7% to below 1.3% is the most graphic manifestation of this correction in the 'reflation trade', with the resultant flattening of the yield curve catching a number of investors off guard and causing a short squeeze in Treasury futures positions that intensified the down-move in yields.

### US TREASURY 10-YEAR YIELD



Source: Bloomberg

### Technical issues at play

Others technical reasons may also have been at play, among them temporarily falling Treasury supply, with the Treasury's General Account at the Fed being drawn down steadily to about USD750 billion at the end of June, from a balance of above USD 1.8 trillion last July. There have also been developments in money markets where the Fed's reverse repo program is raking in hundreds of billions of dollars, hitting almost 1 trillion at the end of Q2.

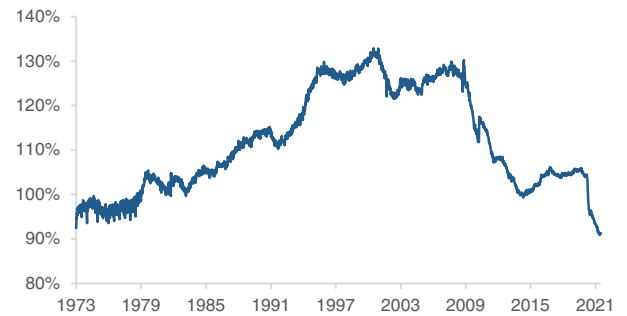
### The role of corporate banks

The huge liquidity balances of the banking sector recycled at the Fed still pose a threat to price stability in the medium term, however, particularly if banks start lending again to the real economy. If all the monetary largesse of central banks stays in the banks, the inflationary threat is muted, or even absent as the additional liquidity never reaches the real economy. However, should the stance of lenders change – and there are indications that this is starting to happen – higher inflation rates could stay with us for longer.

Loan growth started to take off early in the pandemic as the Fed stepped in with more than USD 2tn in lending and supported the provision of bank loans by temporarily relaxing regulatory requirements. The loan growth rate then started to fall in March of this year due to the base effects, with the loan-to-deposit ratio of all US banks reaching 50-year lows.

With the pandemic now arguably in its final stages, thanks to rising vaccination rates in many countries, a return to a pre-pandemic environment should lead to increasing loan growth again which could serve to maintain the recent spikes in inflation for longer. It is no surprise that according to the Fed's latest Senior Loan Officer Survey taken in late March, US banks' willingness to lend was the highest in years.

### US BANKS' LOAN-TO-DEPOSIT RATIO



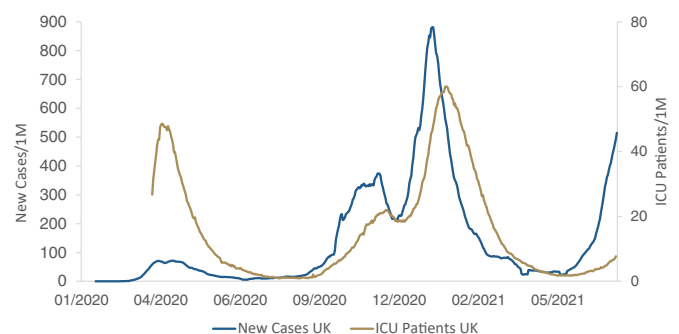
Source: Federal Reserve Bank of St. Louis

There are a number of reasons why banks will now seek to grow their loan books again. The first is the fact that during the pandemic, many households have used their additional stimulus-related income to pay back at least parts of their existing loans. Secondly, when uncertainty was high during the spring of last year, banks took loan loss provisions similar to the extent last seen in the Global Financial Crisis (2008/2009), naturally weighing on the propensity to make new loans. This over-provisioning is now being reversed, as for example with JP Morgan in Q1/21 which released about half of the loan loss provisions taken in the prior year. Thirdly, the steepening yield curve increases the profitability of issuing loans, which are typically refinanced via short-term funding – the classic term transformation of the banking sector.

### Renewed lockdowns?

Finally, another reason for the apparent retreat in bond yields appears to be the fear of renewed lockdowns due to the emergence of new covid virus variants. In the past few weeks, news about rising Covid infection rates in countries where vaccination rates are high (Israel, UK, US) has led some investors to fear a relapse for many economies in the second half of the year due to renewed lockdowns and flare-ups in supply disruptions. The critical variable will be whether the number of hospitalizations remains muted as this would suggest that while vaccinations may not fully prevent new infections with aggressive variants of the virus, they will drastically reduce the probability of any severe disease progression. So long as the vaccines reduce the stress to national health systems, covid-induced restrictions may continue to be relaxed thereby keeping economic activity underpinned. As far as this debate is concerned we appear to be approaching a critical moment as the resolve of governments to resist pressure to lockdown again in coming weeks gets tested - the outcome of which will have a significant bearing over whether the current spike in inflation will in the end be as 'transitory' as the Fed expects.

### NUMBER OF INFECTIONS AND HOSPITALISATIONS IN UK



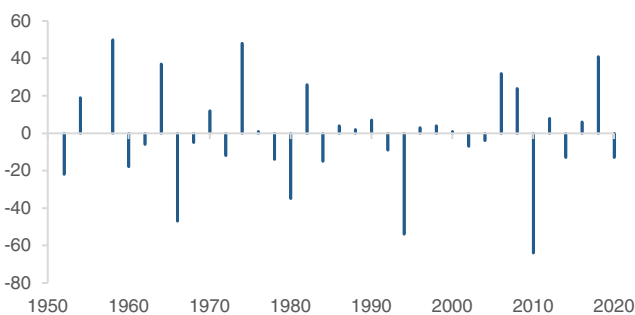
Source: Our World in Data

### Gridlock after midterm elections?

In the US, the Democrats hold the majority in both chambers of Congress, but only by a thread in the Senate (50:50, with Vice President Harris tipping the vote). After President Obama's first election in 2008, the same was true. However, the Democratic party lost direction due to bitter infighting and was not able to make a major imprint on legislation, apart from Obamacare. In the 2010 midterm elections, the Republicans won by an almost 7% margin and took 63 seats in the House of Representatives. The ascent of the 'Tea party' faction in the Republican Party then led to a prolonged period of gridlock, followed by austerity, with the federal budget deficit falling by two thirds from 2011 to 2015 to when it stood at USD 440bn. During the Trump administration the deficit rose back to close to USD 1trn in 2019, in 2020 reached a record level of USD 2.7trn and is expected to rise to USD 3trn this year.

The Democrats will be aware of this risk of a Republican fight-back in the mid-terms and will no doubt seek to pass meaningful legislation to shore up the support of its blue-collar base. This is likely to mean more re-distribution, and rising deficits. The planned American Families Plan (price tag: USD 1.8trn) aims to provide direct support to children and families, but with the current US Congress it will be difficult to get it passed without "reconciliation".

### CHANGES IN DEMOCRATS' HOUSE SEATS



Source: History, Art & Archives

### Reconciliation or no reconciliation?

The US Senate's rules contain the so-called filibuster rule whereby senators can speak as long as they wish for, and on any topic they choose, until "three fifths of the Senators duly chosen and sworn" vote to close the debate. This means that, as long as there are not 60 Senate votes secured for any given legislation, the Upper Chamber is basically blocked from passing any new legislation.

When it comes to budget issues, however, the Congressional Budget Act of 1974 defines a special parliamentary procedure wherein a simple majority can pass amendments to budgetary (spending, revenue, federal debt limit) bills. The Bush tax cuts in 2001, parts of Obamacare and the Trump tax cuts are examples of reconciliation bills, as is the Biden administration's American Rescue Plan of 2021, the USD 1.9trn economic stimulus bill.

In late May, the "Parliamentarian of the United States Senate" who sets the legislative rules and responsibilities decided that the process of budget reconciliation – in other words circumventing the 60 seats' super majority in the Senate – was only allowed once in a fiscal year. As a result, expectations by some market participants of at least another two stimulus bills north of USD 4trn (spread over the coming years) were thwarted and the so-called reflation trade stalled.

We see at least one stimulus bill coming after the Summer, as reconciliation of the 2022 budget is so far "unused". However, it will not be straightforward as there are several Democratic senators from red states that will oppose anything that looks like left-wing progressive legislation which some prominent members of the House would like to bring forward.

The latest news from the Capitol now hints at another USD 3.5trn fiscal package (expenses stretched over 10 years) via the budget reconciliation process, with a late August timing for the legislation to be put together.

### A pause in the reflation trade

The Senate Parliamentarian's ruling of late May triggered a significant correction in those sectors that are seen as benefiting most strongly from a reflation, such as the metals & mining industry which has under-invested in the past years and is having difficulties to increase production meaningfully in the wake of strongly risen demand. We expect some form of infrastructure bill to come to President Biden's desk to be signed, which should increase expected demand for many industrial commodities going forward. Infrastructure investment is also an important topic in other developed regions such as in Europe, leading to even more demand for many commodities. There is another source of demand picking up tremendous speed: efforts at decarbonizing the economy, i.e. the trend away from fossil fuels to more CO<sup>2</sup>-neutral ways of consuming energy. Renewables, in other words, will drive the use in some metals to new highs, further supporting commodity prices.

### METALS & MINING SECTOR RELATIVE TO S&P 500



Source: Bloomberg

The rise in infections with the delta variant has led financial markets to price in an increased probability of the re-emergence of lockdowns, as was visible in the recent strong performance not only of Treasuries, but also vaccine producers as well as work-from-home stocks such as collaboration software providers. While we must be prepared to see setbacks in reflation-related stock sectors, the general direction towards value investing for us is clear for the coming year at least.

### The Dollar's interesting behavior

It has only been two months since core inflation started to jump significantly above the Fed long-term inflation target of 2% p.a. The US dollar since has strengthened by almost 3%. Interestingly, the greenback also gained broadly on the CPI publication dates, which may look somewhat contradictory to purchasing power theory that stipulates that those currencies with higher inflation rates should devalue at the pace of the inflation differential (ceteris paribus, that is) v other currencies.

## US CORE CPI INFLATION



Source: Bloomberg

There is a possible explanation: that higher inflation, which has now reached 4.5% on a year-on-year basis even on the core index (stripping out more volatile prices of energy and food items), leads market participants to expect an earlier monetary tightening. Depending how quickly central banks in other currency regions (EUR, JPY, GBP, CHF) will be releasing their economies from the monetary intensive care unit, an earlier tightening by the Fed translates into an increased yield advantage for yield-starving investors abroad, leading to capital inflows and therefore a strengthening dollar. Our view here is that the Fed will do the utmost not to be the first mover in the tightening cycle, but rather the last. The experience from the taper tantrum in 2013, its first step away from the zero bound in late 2015, and the market turmoil in Q4 of 2018 after a series of rate hikes makes it very difficult for the Fed to risk another premature tightening, which will also be conscious of the negative effects on the rest of the world from a strengthening USD.

### Gold and “digital gold”

The gold price also suffered in June, as fading prospects for more significant stimulus legislation led to a reduction in future inflation expectations (e.g. the 5-year average of inflation, starting 5 years from now) to the lowest in 8 months. With every further (core) CPI print at levels unseen in almost 30 years, the market may yet become somewhat less sanguine on the price front, especially if there is further evidence of substantial wage inflation coming to the fore. Precious metals therefore should keep their attractiveness for investors, in our view, for protecting purchasing power.

The same argument applies to digital assets or cryptocurrencies. Having witnessed a period of flourishing investor optimism from October of last year until mid-May, during which investor sentiment indicators almost throughout signaled high levels of greed, digital assets are now undergoing a correction and sentiment has been stuck in the fear zone for two months straight. While the technical picture would allow for another downleg into the lower 20'000s in the case for bitcoin, we remain firmly convinced that all the developments in the economic, monetary, and political sphere speak in favor of a longer-term continuation of the digital assets success story. The amount of work going into many projects is impressive and progress in adoption is marching on. According to coinmarketcap, total crypto market capitalization has dropped by 48% since the high in mid-May to USD 1.3bn. Thanks to the enormous potential in applications and the resulting demand for digital assets (apart from a growing embrace by institutional investors), we are confident that we will see a multiple of the current market cap on a longer-term horizon. For the short term, it will be informative to see whether the support around 30K for bitcoin will hold through summer: should it do so, the case for a bottom would be strong and an attack on the all-time highs not far away.

## CONCLUSION

- ▶ The past weeks have seen a retreat of US bond yields, due to several reasons, among them the fear of renewed lockdowns due to the emergence of new virus variants, a perceived more hawkish stance by the US Fed and also technical factors such as one-sided positioning in bond futures markets leading to some form of a short squeeze.
- ▶ Given where we are today, growing vaccination rates are strongly reducing the number of hospitalizations and therefore avert a relapse into lockdowns. A further crippling of the economy and supply chains is therefore likely to be avoided, although some temporary constraints might be seen in certain countries.
- ▶ The full throttle monetary support by major central banks continues. Even if the mid-June meeting of the FOMC led to slightly higher longer-term rate expectations by the market, the currently expected timing of the rates lift-off (somewhen in 2023) to us remains an extremely dovish outlook – considering a CPI headline inflation rate north of 5%.
- ▶ The transmission of monetary policy via the corporate banking sector will play an important role to the economic outlook for 2022 and beyond. Banks have ample liquidity to lend and the strong economic growth rate should drive up loan demand.
- ▶ For the summer months, the tug of war between the view of the current spike in inflation being ‘transitory’ and the view of “inflationistas” will continue. Signs of new covid-variants with potential immunity against current vaccines must be looked out for.
- ▶ The recent correction in reflation-related stocks, such as mining and commodity-related companies, offers an opportunity to add to positions. We deem it noteworthy that valuations remain modest in many of these stocks, even at the prospect of a strong uplift in earnings based on a continued strong performance of commodity prices.
- ▶ Digital assets are also deemed to be in a corrective phase before a likely recovery is seen later in the year.
- ▶ The financial markets could see some higher volatility over the summer months, as there appeared to be a general sense of invincibility with equity investors – lower yields are good for stocks at some times, whereas higher yields are a sign of healthy growth rates, which are by themselves paradoxically good for equities, too. Some reassessment will have to take place, in order to wash out the one-way mindset (“the market can only go up!”) on behalf of investors.

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