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Compass

3rd Quarter 2022

Inflation in different economic areas

Different measures of inflation

Importance of inflation for financial markets

Inflation, rising interest rates and the Ukraine war

Consumer prices have been rising steadily for more than a year and have now reached multi-decade highs in many countries. The unusually high inflation cannot be attributed to a single cause, rather it is the result of a variety of different factors. Bottlenecks in global supply chains, Corona-related lockdowns and exceptionally expansionary monetary and fiscal policies during the pandemic are just some of the reasons why inflation has accelerated so much. In addition, energy and food prices have risen sharply in the wake of the Ukraine war, putting a noticeable strain on private household budgets. How high the inflation rate is depends largely on how it is measured. Various measurement methods are used today, which differ mainly in the composition of the underlying basket of goods and services. But regardless of how inflation is measured, a clear acceleration of inflation cannot be ignored. Many investors are therefore asking how they can hedge against increasing price pressures. To answer this question, we look at the most prominent asset classes: equities, bonds, currencies and gold. In past times of high and rising inflation, investors were well advised to invest in gold. Equities also yielded positive returns, even though inflation does not affect all equity sectors to the same extent.

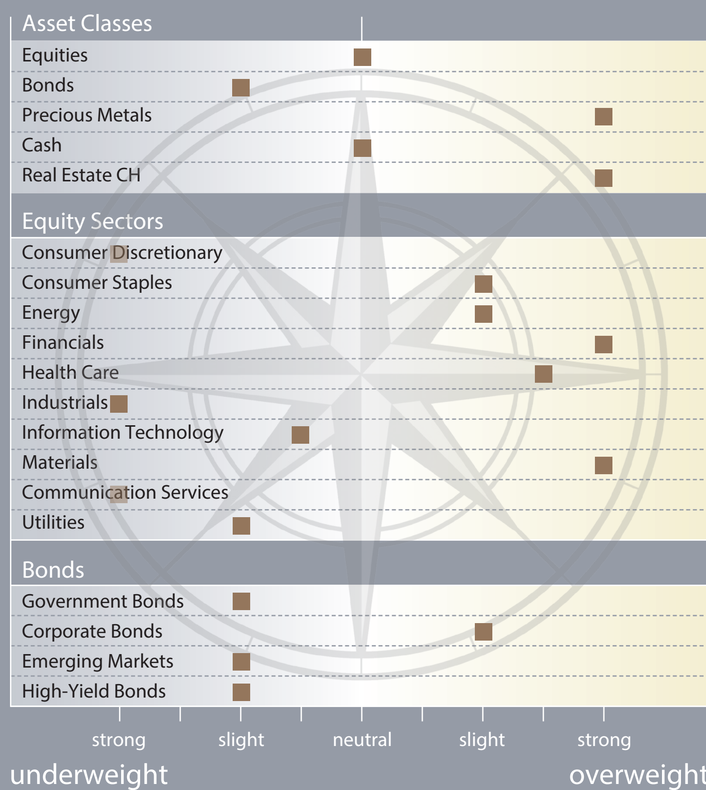
Investing in times of high inflation

In view of the ongoing geopolitical uncertainties, we expect central banks to act prudently. Once inflation figures have peaked and begin to return to more normal levels, equity markets should benefit from some tailwind. Until then, we maintain our defensive asset allocation.

Currently, inflation rates in some countries are well above 6% and there is no sign of inflation slowing down. We are taking this situation into account in our tactical equity allocation by overweighting both the energy and materials sectors. Likewise, we maintain an overweight to the defensive health care sector, while underweighting the consumer discretionary, industrials and information technology sectors.

A key factor for the valuation of gold is the development of real interest rates, i. e. nominal interest rates minus inflation. The higher real interest rates are, the less attractive gold becomes. In the current situation, however, geopolitical uncertainties in connection with the Ukraine war must also be taken into account. As a result, the demand for gold has strengthened. We therefore maintain our overweight position in gold.

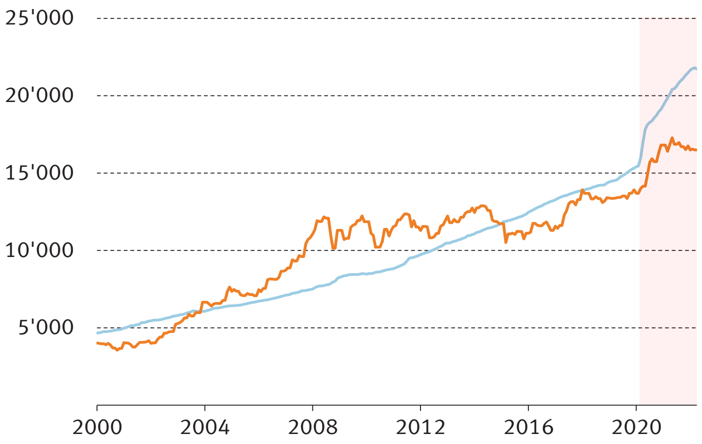
Asset allocation recommendation as of July 1st, 2022 for investors with CHF as their reference currency.



Current Topic:
Inflation in different economic areas

Current Topic 1:

USD billions

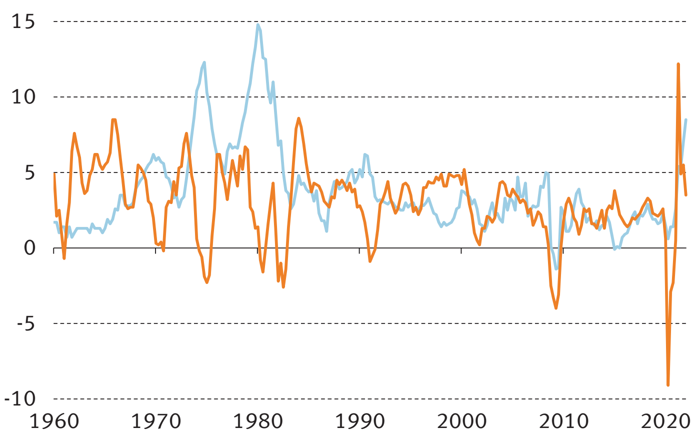


Inflation drivers

Inflation in the Eurozone and the US has been rising steadily for more than a year and has now reached its highest level in several decades. The unusually high inflation cannot be attributed to a single cause, rather it is the result of a variety of different factors. On the one hand, energy and food prices have risen sharply due to the Ukraine war, which has put a noticeable strain on private household budgets. Secondly, global supply chain bottlenecks, covid-related lockdowns in China and an exceptionally expansive monetary and fiscal policies during the pandemic have fuelled inflation. Also contributing to the inflationary environment are above-average goods consumption and the trend towards renewable energy.

Current Topic 2:

Percent p. a.

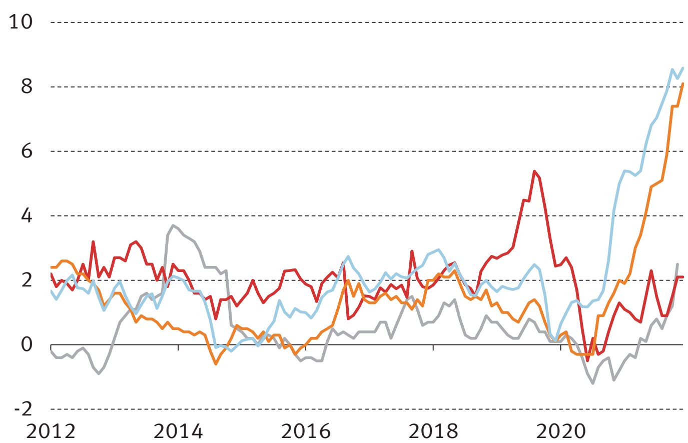


Inflation and economic growth

The relationship between inflation and economic growth was and is a central area of research in economics. Until the 1970s, it was believed that a government could increase growth by accepting higher inflation. But when inflation rose sharply in the following years while the economy grew only slightly or even shrank, this relationship was increasingly questioned. Today, the majority of economists agree that high inflation has a negative effect on economic development. High inflation reduces the willingness of companies and households to invest and consume due to higher uncertainty. Stable, low inflation around 2%, on the other hand, can be beneficial for growth.

Current Topic 3:

Annual inflation rate (CPI) in percent



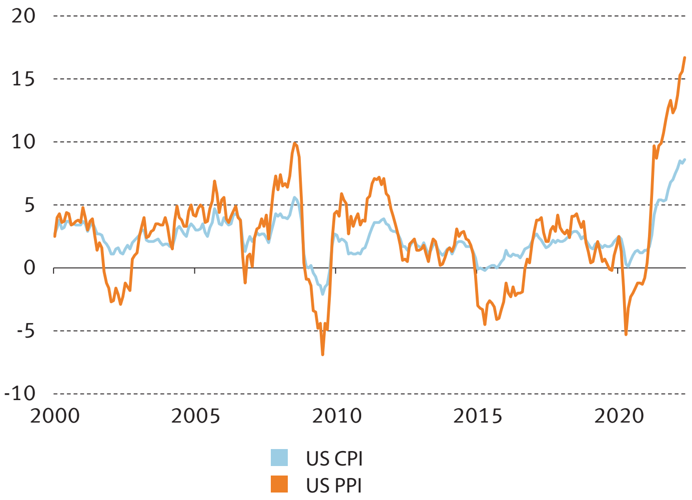
Inflation in different economic areas

If we compare the four largest economic areas in terms of their inflation dynamics, we can see some differences. In spring 2021, inflation in the US already began to rise sharply. One reason for the relatively rapid and strong increase are the direct payments to US households that were included in the Covid stimulus package, which resulted in a considerable increase in demand for goods. In the Eurozone, inflation rose later than in the US and accelerated massively after the outbreak of the Ukraine war, which can mainly be attributed to higher prices of oil and gas. Inflation rates in China and Japan are comparatively low, but have also risen in recent months. Japan in particular, which previously had to contend with deflationary forces, is now showing positive inflation.

Knowledge & Experience: Different measures of inflation

Knowledge & Experience 1:

Annual inflation rate in percent

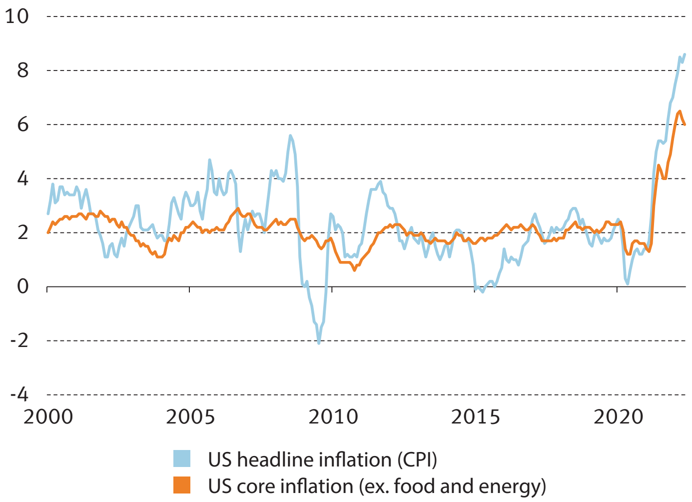


Consumer Price Index and Producer Price Index

Consumer Price Index (CPI) and Producer Price Index (PPI) both measure the price increase of a defined basket of goods and services. However, the content of the basket is different. The goods and services included in the CPI are those typically consumed by residents of urban areas. The CPI corresponds to the average price change of each item in the basket. This includes food, housing, clothing, transportation and communications, among others. In contrast, the PPI measures the change in the selling prices of raw materials and semi-finished goods. These include mining, manufacturing, agriculture and construction. Because these selling prices directly affect retail prices, the PPI is considered a leading indicator of inflationary pressures.

Knowledge & Experience 2:

Annual inflation rate in percent

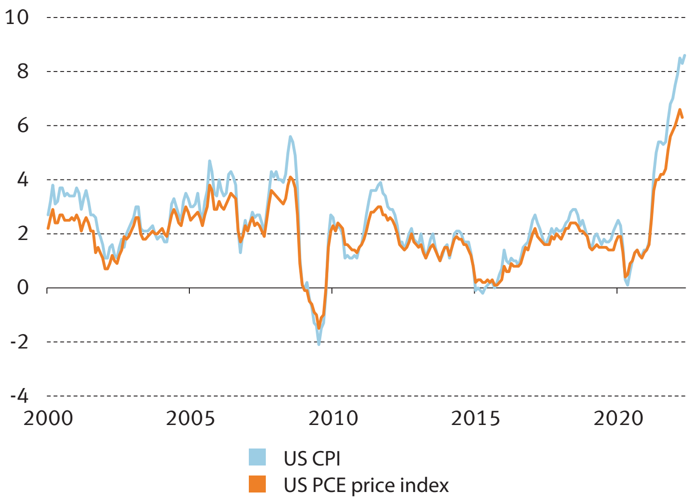


Headline inflation and core inflation

Headline inflation is the inflation figure shown as the consumer price index. It shows the change in the cost of living and includes all inflation-relevant goods and services of an economy. Core inflation removes the CPI components, which can fluctuate widely from month to month, leading to an undesirable distortion of the overall figure. The most commonly removed components are food and energy. Their prices are often affected by external shocks that cannot be controlled by a single economy. Such external shocks are, for example, extreme weather events that have a negative impact on agriculture or the war in Ukraine, as a result of which the price of oil has risen sharply.

Knowledge & Experience 3:

Annual inflation rate in percent

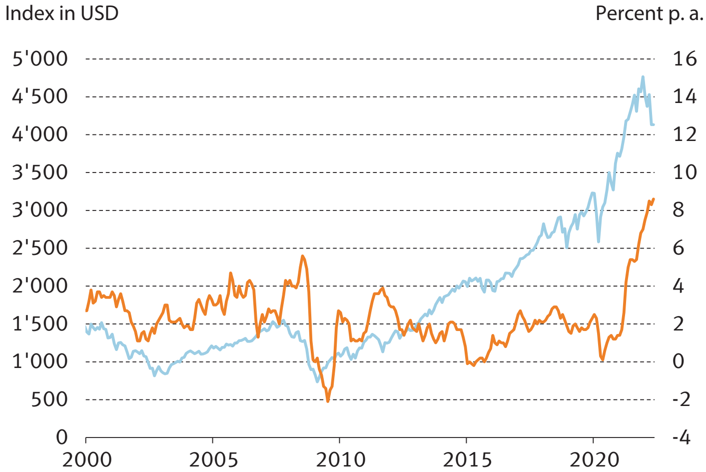


Personal Consumption Expenditures price index

The US Federal Reserve defines its inflation target using the Personal Consumption Expenditure (PCE) price index rather than the CPI. While both indices calculate the price level based on the prices of a basket of goods and services, the CPI only captures spending on items that are paid for out of pocket. Other expenditures that are not paid for directly are only included in the PCE. These include, for example, medical care paid for by employer-provided insurance. The most important difference, however, is how the two indices account for changes in the basket of goods. Unlike the CPI, the PCE takes into account the substitution of goods and adjusts the basket accordingly. For example, if the price of bread rises, people buy less bread and the weight in the PCE basket falls, while the CPI basket does not change.

Basic Trend:
Importance of inflation for financial markets

Basic Trend 1:

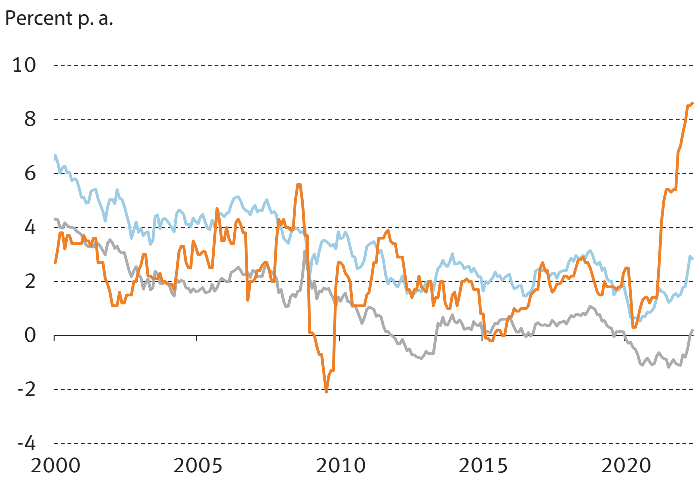


S&P 500 Index (left-hand scale)
US inflation (CPI, right-hand scale)

Equities

When inflation is moderate and stable, equities perform particularly well because uncertainties are low and corporate profits can be forecast precisely. Sudden price increases, however, are a risk for operating margins because increased production costs can only be passed on to customers with a delay. Higher inflation rates are forcing central banks to pursue a more restrictive monetary policy with higher interest rates, which is causing equity valuations to shrink due to rising discount rates. In addition, measures to combat inflation are depressing the growth outlook and thus increasing pressure on equities. The materials sector as well as companies that can quickly pass on rising production costs to their customers should be preferred under these circumstances.

Basic Trend 2:

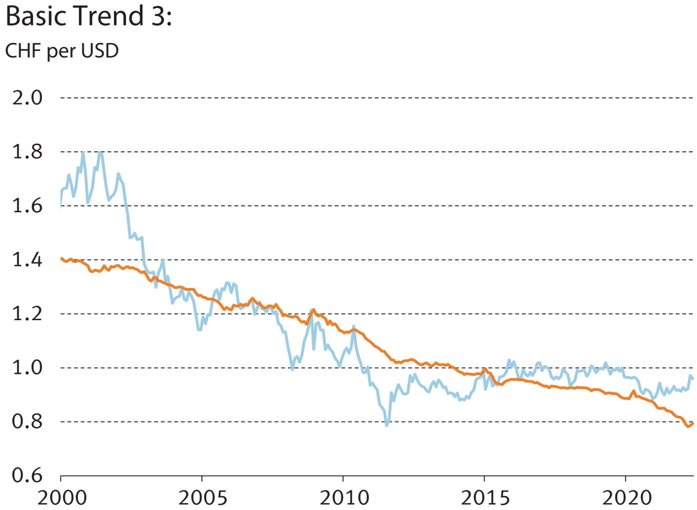


Yield on 10-year US Treasuries
Yield on 10-year US TIPS
US inflation (CPI)

Bonds

Bonds with a fixed coupon and predefined repayment at maturity (nominal value) are highly dependent on changes in inflation. The fixed coupon payments reflect inflation expectations at the time of issuance and are not subsequently adjusted even if market conditions change. If inflation accelerates, the discounted future coupon payments and repayments at maturity are worth less today, resulting in the devaluation of bonds. The longer the remaining term of the bond, the greater the loss. Treasury Inflation-Protected Securities (TIPS), on the other hand, offer sustainable protection against rising inflation. The nominal value of TIPS is linked to realised inflation and thus guarantees a real return that is independent of inflation.

Basic Trend 3:



Exchange rate CHF/USD
Fair exchange rate CHF/USD according to PPP

Currencies

The theory of purchasing power parity (PPP) states that the exchange rate between two currencies is in equilibrium when the purchasing power in both countries is identical. This means that the exchange rate between two countries should be equal to the ratio of the price levels of the two countries for a fixed basket of goods and services. If the domestic price level of a country rises, then that country's currency must devalue and become correspondingly cheaper to return to equilibrium. Hence, in the long run, currencies tend to adjust their exchange rates to the respective inflation differentials. In the short run, however, economic data and financial market influences such as monetary policy or interest rate differentials tend to drive exchange rate movements.

The prices used in our analysis are end-of-period prices. The figures used for our valuation model are estimates referring to dates and therefore carry a risk. These are liable to change without notice. The usage of valuation models does not rule out the risk that fair valuations over a specific investment period cannot be attained. A complex multitude of factors influences price developments. Unforeseeable changes could, for instance, arise from technological innovations, general economic activities, exchange-rate fluctuations or changes in social values. This discussion of valuation methods makes no claim to be complete.

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