Compass

3rd Quarter 2024

Anatomy of inflation in US and Europe

Narrow ridge for soft landing

Investments for different growth and inflation regimes

Your wealth, our responsibility.

Central banks have not yet reached their targets

For more than two years, monetary authorities on both sides of the Atlantic have been keeping a tight rein on monetary policy, but inflation rates are still above their comfort zones. In Europe, price stability is within reach. Energy prices have normalised and second-round effects are easing. In the US, on the other hand, core inflation is only returning very slowly. Even after the full return of people of prime working age (25-54 years) to the labour market, a shortage of skilled workers persists. The wage-price spiral can therefore only be broken by an economic slowdown. However, the US economy remains in a reflationary regime with robust economic growth, partly because the government's subsidy programs are undermining the restrictive interest rate policy of the Federal Reserve System (Fed). It is still unclear whether the economy will manage a soft landing or whether a recession or even prolonged stagflation is looming.
In the final section, we look at the expected performance of asset classes and equity sectors in various growth and inflation regimes. Once again, gold shines as a portfolio stabilizer. Within equities, mega-caps in the technology sector are in a class of their own. However, these equities are currently priced accordingly high.

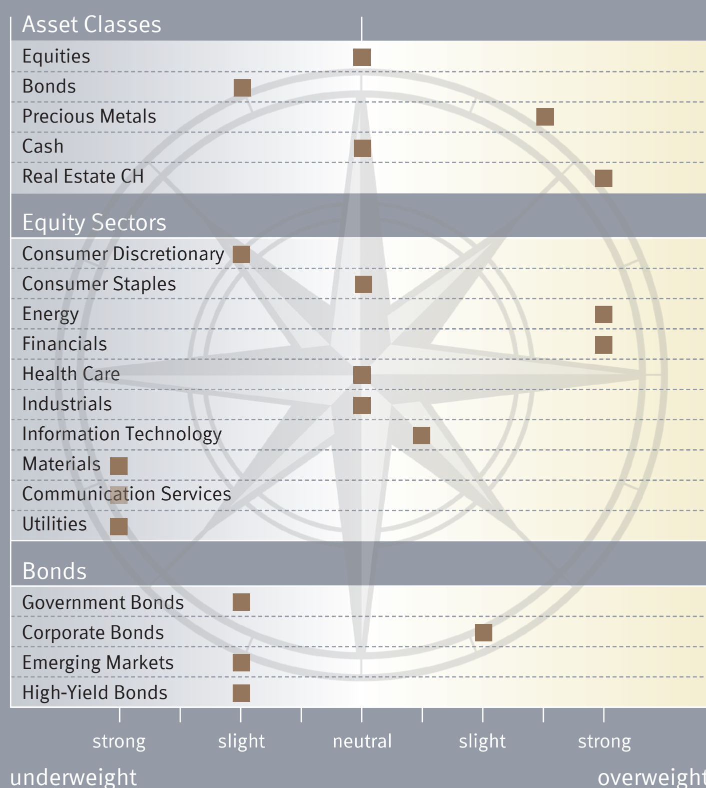
Diverging equity markets

Global growth remains robust, especially in the US. Due to stubborn but moderate inflation, the Fed will delay interest rate cuts. Geopolitical risks, exaggerated market sentiment and positioning could trigger a pause on equity markets.

The equity market rally has led to the overvaluation of some market segments. In such an environment, the careful selection of investments becomes increasingly important. Due to the improvements made in the development and application of AI technologies, we increased our weightings in the industrial and IT sectors. In contrast, we reduced the overweight in the healthcare sector due to political dynamics in connection with the US elections. We also reduced the weighting of the materials sector due to declining momentum.

The economic environment suggests that credit risks are likely to remain low. Nevertheless, we recommend critically examining the credit quality of issuers and holding only bonds issued by first-class borrowers. In view of a macroeconomic environment characterised by geopolitical tensions, we remain overweight in gold. Encouraged by the SNB's repeated interest rate cut, we maintain our strong overweight in Swiss real estate.

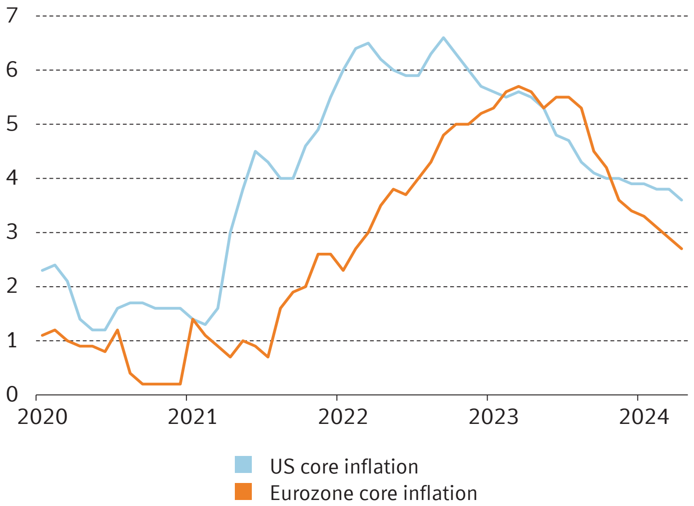
Asset allocation recommendation as of July 1st, 2024 for investors with CHF as their reference currency.



Current Topic:
Anatomy of inflation in US and Europe

Current Topic 1:

Percent



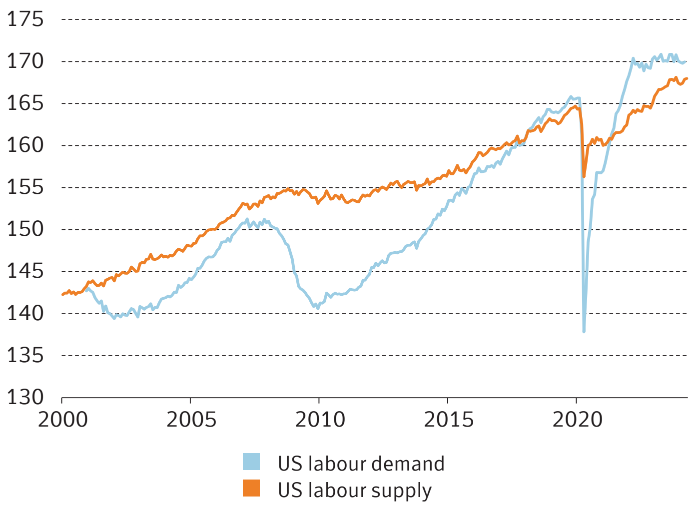
Different drivers of inflation

At first glance, the inflationary spikes in the US and Europe following the pandemic may appear similar. However, a closer look reveals significant differences in the underlying price pressure. In the US, wage inflation is the main driver of inflation, while in Europe the energy shock resulting from the war in Ukraine is driving inflation and wage inflation is more a consequence of it. This becomes clear when considering the timing of the rise in inflation. US inflation rose as soon as the economy regained momentum. In January 2022, core inflation in the US had already reached 6%, while it was still at moderate 2.3% in the eurozone. Inflation in the eurozone only accelerated with the war in Ukraine and the drastic rise in energy prices.

Current Topic 2:

Source: FRED

Millions of people



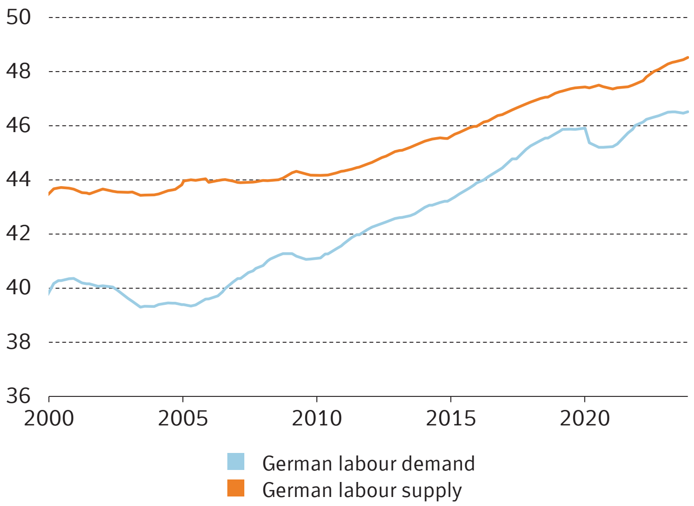
Inverted US labour market

During the COVID-19 pandemic, the US granted extensive support payments to the population, which resulted in large private savings. As a result, American workers were slow to return to the labour market as the economy recovered, and many older workers did not return at all. Since labour demand exceeded supply, there were more vacancies than unemployed people and wages rose. From mid-2022, the prime-age labour force participation rate began to normalize, which reduced wage inflation. Today, however, labour force participation has peaked and the positive effect on labour supply is exhausted. In order to close the gap between labour demand and supply, demand must therefore fall.

Current Topic 3:

Source: BCA

Millions of people



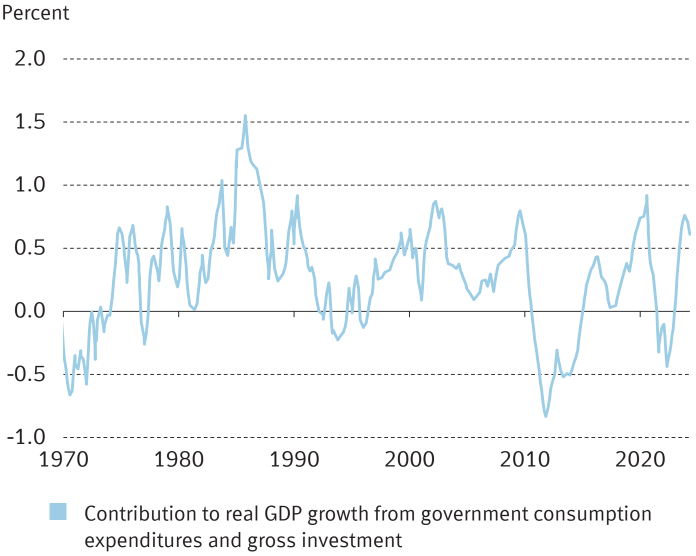
Wage inflation as a result of the energy shock

In theory, energy prices should not influence core inflation, as this excludes food and energy prices. Nevertheless, rising energy costs have an indirect impact by increasing production and transportation costs and raising inflation expectations. As a result of the Ukraine war, energy inflation in the eurozone skyrocketed to almost 50%, which also massively increased core inflation. The long-lasting inflation in the eurozone ultimately led to wage and pension increases because these are linked to inflation. In Europe, wage inflation therefore is a result of the inflation caused by the energy shock and not its source. With the decline of core inflation, wage inflation has fallen in recent months. Despite the alleged shortage of skilled workers, the relatively relaxed situation on the European labour markets also contributed to this development.

Basic Trend:
Narrow ridge for soft landing

Basic Trend 1:

Source: BCA

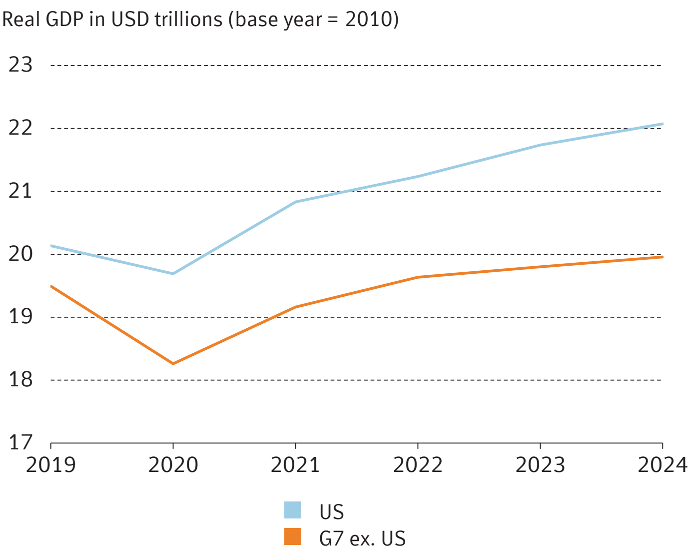


US fiscal policy remains expansionary

In addition to the structural labour shortage, the government's spending spree is a key factor in the imbalance on the US labour market. Following the expiry of the coronavirus stimulus package, the contribution of government spending to growth was negative for a while. However, the excess savings built up by private households at that time have only now been slowly reduced and have kept consumer demand high for a long time. Today, the fiscal stimulus is positive again, which is unusual in a boom phase. The programs initiated by the Biden administration to promote critical industries, in particular the "Inflation Reduction Act", are responsible for this. Contrary to what the name might suggest, the investments promoted by the subsidies are fuelling inflation for the time being.

Basic Trend 2:

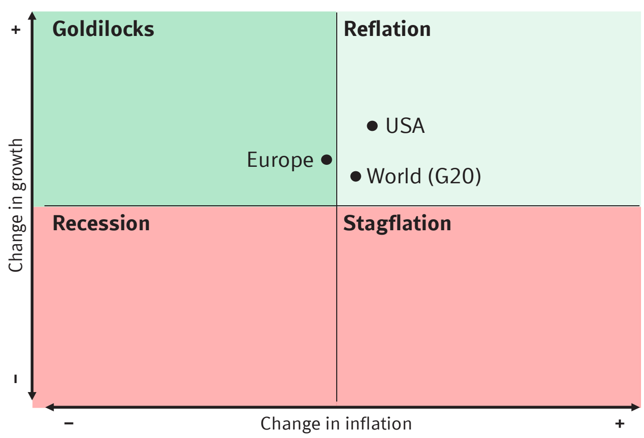
Source: OECD



US as the engine of global growth

Investment programs and robust consumption give the US a growth advantage over other industrialised countries, of which Germany and Japan are weakening in particular. Four macroeconomic regimes can be derived from the growth and inflation dynamics, which dictate the rules of the game for monetary authorities. Until the Covid shock, the global economy operated in a goldilocks regime for a long time. Low price pressure due to a sufficient supply of goods and services enabled low interest rates, which stimulated consumption and ensured stable growth. The demand shock then led to a brief and severe recession. Since then, a reflation regime has dominated with stagflationary interruptions due to supply bottlenecks and the Ukraine war.

Basic Trend 3:



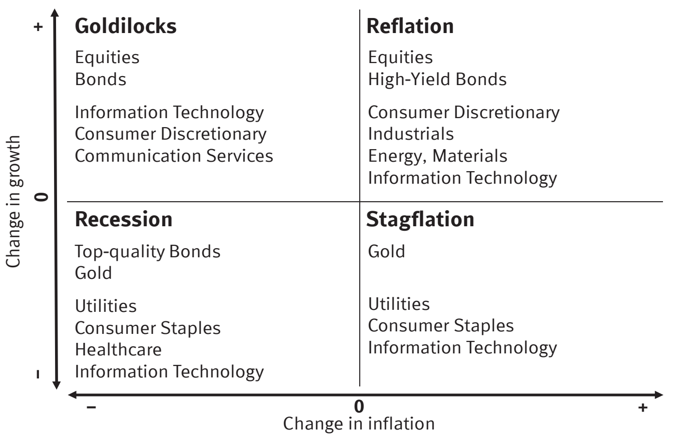
Monetary policy remains restrictive for longer

The high interest rates are intended to curb consumer demand in a controlled manner and bring the economy back into a goldilocks environment with a soft landing. Our model based on leading indicators suggests that this endeavour is likely to take some time in the US. The European Central Bank (ECB), on the other hand, has already embarked on a cautious easing course. In any case, the central banks will want to avoid structural stagflation, as their hands are tied in this regime and their twin goals of full employment and price stability cannot be achieved. Monetary policy on both sides of the Atlantic is therefore likely to remain restrictive for a little too long and the risk of a hard landing with a brief recession will be accepted.

Knowledge & Experience: Investments for different growth and inflation regimes

Knowledge & Experience 1:

Advisable investments for the four macroeconomic regimes



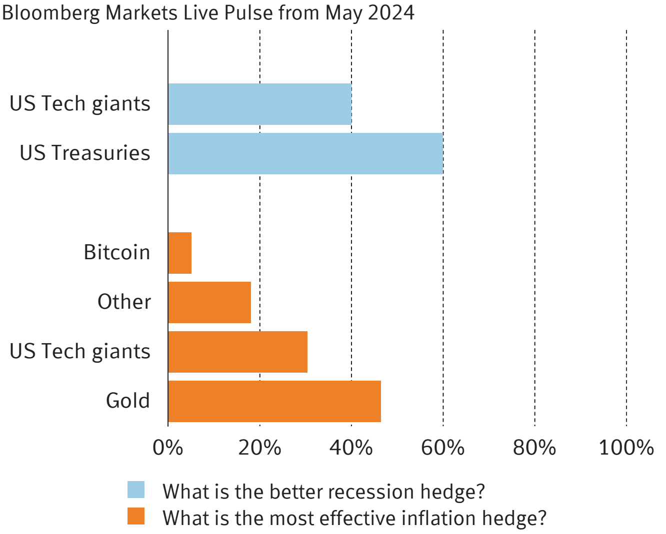
Effects of growth and inflation

Real economic growth is the primary driver of corporate profits. High inflation also increases nominal profits. However, the higher interest rates in inflation regimes depress equity valuations and are particularly detrimental to bond prices. Accordingly, stagflation is also the most challenging regime for investors, as only gold can be expected to make a clearly positive contribution to returns. Equities will perform better than bonds, but will at best be able to maintain their real value (adjusted for inflation). In a recession scenario, first-class bonds and gold should provide stability and rapid monetary easing should form the basis for their recovery after an almost certain equity market correction.

Knowledge & Experience 2:

Source: Bloomberg

Percentage breakdown of responses based on the latest survey results from the Bloomberg Markets Live Pulse from May 2024

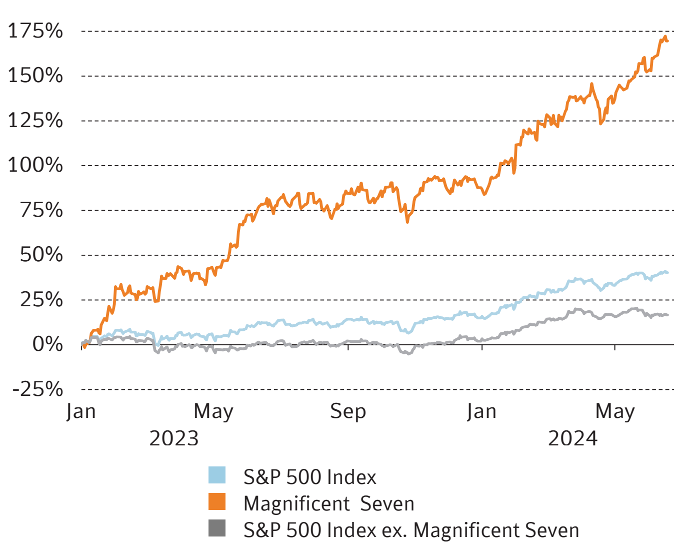


The technology sector is in a class of its own

Within equities, the technology sector is best positioned to weather the various regimes. Tech giants such as Microsoft and Apple now have a high proportion of recurring earnings, which has reduced their cyclicality. Semiconductor companies are also less dependent on economic fluctuations thanks to the huge demand from investments in artificial intelligence (AI). Their pricing power also allows the tech giants to deal well with inflation, so that they are now competing with gold as the preferred instrument for real wealth preservation. As a result, the sector is particularly sought after in times of high uncertainty and has outperformed cyclical sectors such as industrials and consumer discretionary even in the recent reflation regime.

Knowledge & Experience 3:

Indexed performance in USD



Market breadth is dwindling

In addition, AI fantasies are contributing to the fact that the share prices of tech giants are increasingly decoupling from the real economy and the rest of the equity market. The "Magnificent Seven" index, consisting of the technology-related US mega-caps Nvidia, Microsoft, Apple, Alphabet, Amazon, Meta and Tesla, has gained 175% since the introduction of ChatGPT at the end of 2022, while the S&P 500 would have stagnated without these champions. After the price fireworks, their combined weight in the US index is now 33% and in the global index MSCI World 22%. This means that market breadth is narrower than ever before. The ambitious expectations for these stocks make the US index appear expensive with a price/earnings ratio of 25, although the rest of the market is moderately valued. While valuation has rarely been a good indicator for tactical timing, it does give an indication of the long-term return potential of equities.

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