Investment Views

September 2021

Transient, taper or tantrum?

Global inflation has risen further than forecast. Aggregate demand, boosted by rising capital investment, inventory rebuilding and a recovery in consumption has challenged supply that is hamstrung by logistics disruption and labour shortages. US CPI rose 5.3% pa in August, with UK and European prices rising at a 3% rate; the latter is a decade high. The main outlier is China, where an increase of 0.8% is significantly lower than the 3% government target.

At the same time, GDP growth is slowing as emergency fiscal support falls away, the burst of reopening activity wanes and delta drags. The Citigroup US economic surprise index, a measure of economic outcomes versus expectations, stands at -39% suggesting that recent data has fallen far short of forecasts. For now, this reflects a moderation in growth, rather than a recession.

Whilst CPI is a backward looking indicator, the slowing GDP narrative underpins a coordinated message from all the major Central Banks that the uptick in inflation will prove transient, as supply chains normalise and employment participation recovers. Whilst this may be so, at the start of this year US CPI was forecast to rise 3% in 2021 and 2% in 2022. Those estimates now stand at 5% and 3% respectively. Similarly, UK consumers see inflation averaging 3% pa over the next 5 years (source: Bank of England), whilst German CPI growth is expected to touch 5% over the coming months. All of which beggars, “how long is transient?”

For now, asset markets are buying Central Bank CPI assertions and their confidence that they can wind down QE bond purchase programs. In a recent survey, 65% of respondents said they expect the Federal Reserve to taper QE during the fourth quarter, up from 25% in August (source: Isabelnet.com). Absent a poor employment number, the Chairman of the Federal Reserve, speaking on the 22nd September, validated this view despite trimming the 2021 GDP growth forecast from 7% to 5.9%.

The consensus seems to agree with the Fed prediction of an end to QE bond buying and a first rate rise during 2022. We see a more nuanced picture. For one, Central Banks have to persist with their transient mantra even in the face of higher than expected inflation. Whilst year-on-year comparisons suggest CPI will moderate during the first half of 2022, if workers start to expect a more prolonged period of rising prices, demands for above inflation pay increases could trigger a wage/price spiral. Central Banks are thus keen to control the inflation zeitgeist as this autumns wage negotiations kick-off.

We also note that monetary policy is now globally coordinated with all Central Banks talking about tapering and transience. This unity of message makes it more effective and reduces the probability of investors calling out a particular country. If the Central Banks move in lock step, investors are less likely to differentiate between the relative merits of individual countries, their bonds and currencies. Conversely, if a country or economic block breaks ranks, investors might well single out the monetary 'Judas'.

Investor tolerance for deficits and money printing is predicated on the relative merits of the major currency blocks. If everyone is equally indebted and profligate, no one is "best" or "worst". In this respect, it is interesting to note the collapse in currency volatility with the US dollar index (DXY) trading in a 5% range for the last 12 months.

How long this monetary accord can last is a moot point as the economic fortunes of the EU, US and China start to diverge. As these differences grow, pressure will rise to tailor policy to local imperatives. We will also be reminded of the inter-linked nature of the global economy. The pending bankruptcy of Evergrande, until recently the world's largest property developer, and the aggressive deleveraging of the Chinese property sector could have wider implications. With 27% of Chinese bank loans linked to real estate, domestic demand needs an orderly property sector, as do the commodity producing nations that feed this growth engine. US monetary policy may yet be swayed by events In Asia.

In the meantime, we are monitoring wage data, inflation expectations and various CPI constituents. Key amongst these are housing costs, although the spike in oil and gas prices has not gone unnoticed. Just under 25% of the US CPI basket is informed by a survey that estimates the cost of renting a US home (the owners' equivalent rent or OER). Every month, the Bureau of Labour Statistics asks a cross section of homeowners "If someone were to rent your home today, how much do you think it would rent for monthly, unfurnished and without utilities?" The answers are captured in an index that rises and falls in line with the estimates. It often deviates from recorded property inflation, as laypeople are poorly placed to judge rental values. Indeed, in August this survey registered 2.6% annual growth, compared to a 19% rise in the US home price index of sold properties. The OER could be chronically under-estimating moves in house prices. Given how important the cost of shelter is to people's views on future inflation, this variance bears watching.

To us, Central Bank talk of transient price rises and a steady withdrawal of QE is an attempt to anchor inflation expectations. Whilst we do not doubt the desire to row back from 13 years of QE, the authorities are trapped by the debts that this policy has both encouraged and sustained. A recent report by the Institute of International Finance estimates that global indebtedness hit $296 trillion by the end of June or 353% of GDP. That's a 20% rise on pre-pandemic levels and compares to 280% before the 2008 financial crisis. With the yield on G7 Government benchmark bonds averaging 0.6% pa and corporate bond yields at or near all-time lows, these debts are sustainable. However, any rise in yields or corporate spreads would rapidly choke economic activity and trigger a wave of defaults. The global economy is acutely sensitive to prevailing rates.

Absent some form of debt jubilee, financial repression is the only way to reduce indebtedness that avoids a precipitous economic slowdown and supports deficit funded, post-covid fiscal promises. We have already entered a multi-year period where interest rates will be held below inflation, akin to the decade after World War 2 when nations engineered negative real rates to help erode conflict debts.

Perversely, this could support equity markets. Absent run-away inflation or a sharp economic contraction, low real rates would continue to make the earnings yield on equities relatively attractive, with surplus liquidity chasing any stock that shows sustainable, above average growth. Whilst equities look over-bought at current levels and thus ripe for a pull back, indices could well grind higher if it is tapering, not inflation, which proves transient.

Policy Matrix Summary

The matrix below is a summary of our current 12-24 month outlook for the various equity, bond and commodity markets that we monitor. It shows areas where we are either positive or negative; for all other asset classes, we have a neutral view. It is not intended as anything other than a high level guide on where we stand at this time.

12-24 Month view	Overall	Equities	Bonds	Alternatives
+	Alternatives	Gold Miners China A Shares UK Small Companies Japan Value ESG & Impact funds FinTech & Blockchain	Inflation-linked, Emerging Market, China	Gold, Volatility Strategies
−	Bonds	European US	UK European Japanese High Yield	

All performance numbers show % changes except for bond yields which show yield changes.

	31 Aug 21	-1 Mth	-3 Mth	-12 Mth
CURRENCIES (VS USD)				
GBP	1.3755	-1.1%	-3.2%	2.9%
CHF	1.0926	-1.1%	-1.8%	-1.3%
AUD	0.7316	-0.4%	-5.4%	-0.8%
JPY	110.0200	0.3%	0.4%	3.9%
EUR	1.1809	-0.5%	-3.4%	-1.1%
BOND YIELDS (10 yr)				
UK	0.71	0.15	-0.08	0.40
US	1.31	0.09	-0.29	0.60
Germany	-0.39	0.08	-0.20	0.01
Australia	1.16	-0.03	-0.56	0.17
Japan	0.02	0.00	-0.06	-0.03
EQUITIES				
US. S&P 500 (USD)	4,522.68	2.9%	7.6%	29.2%
UK. FTSE 100 (GBP)	7,119.70	1.2%	1.4%	19.4%
FTSE Europe Ex UK (local)	340.90	2.2%	6.4%	29.9%
Japan. Topix (JPY)	1,960.70	3.1%	2.0%	21.2%
China. Shanghai Comp (RMB)	3,543.94	4.3%	-2.0%	4.4%
HK. Hang Seng (HKD)	25,878.99	-0.3%	-11.2%	2.8%
Australia. All Ords (AUD)	7,823.28	2.1%	5.6%	25.3%
FTSE Asia Pac ex Japan	693.49	2.0%	-5.2%	18.0%
FTSE World (USD)	877.64	2.3%	4.8%	28.2%
FTSE World (GBP)	945.45	3.3%	8.3%	24.7%
COMMODITIES				
Oil (WTI)	68.50	-6.5%	5.4%	52.0%
Gold	1813.62	0.0%	-4.9%	-7.8%

Disclaimer/Regulation

How to subscribe to Investment Views

If you would like to receive a free copy of Investment Views by email at the start each month, please contact us at UK@bentleyreid.co.uk. We publish a digital and audio version. Alternatively, Investment Views is available on the Bentley Reid App or via our website (www.BentleyReid.com); go to the Investment Views section. This also houses our quarterly market commentaries and in-depth investment interviews.

Instructions for downloading the Bentley Reid App on Apple devices:

The App can be downloaded onto Android and Apple devices.

1. Scan or click the QR code or search for 'Bentley Reid' in the relevant App Store. For Apple devices the search must take place in the 'iPhone Apps' section, which sits at the top of the screen, regardless of the device being used. If you search in the 'iPad Apps' section no results will appear.

2. Install the app and click 'Open'.

3. Once the app is installed, to ensure you receive a pop up notification that new publications have been posted, go to the general 'Settings' section on your device and then choose 'Notifications'. Scroll down on the right hand side and select Bentley Reid. In the 'Notification Center' section choose 'On,' the type of 'Alert Style' you would like and then return to the main screen.

Contacts and Regulation

Published and distributed in UK by **Bentley Reid & Co (UK) Limited**
29 Queen Anne's Gate, London SW1H 9BU, England
Tel +44 (0) 20 7222 8081, Fax +44 (0) 20 7227 8440, Email UK@bentleyreid.co.uk
Authorized and regulated by the Financial Conduct Authority, registered office 29 Queen Anne's Gate, London SW1H 9BU. Registered Number 07602886

Published and distributed outside the UK by **Bentley Reid & Co Limited**
24 Floor Diamond Exchange Building, 8-10 Duddell Street, Central, Hong Kong
Tel +852 2810 1233, Fax +852 2810 0849, Email HK@bentleyreid.com
Licensed by the Securities and Futures Commission in Hong Kong

The content of this document is for information purposes only. The authors believe that, at the time of publication, the views expressed and opinions given are correct but cannot guarantee this and readers intending to take action based upon the content of this document should first consult with the professional who advises them on their financial affairs. Neither the publisher nor any of its subsidiaries or connected parties accepts responsibility of any direct or indirect or consequential loss suffered by a reader or any related person as a result of any action taken, or not taken in reliance upon the content of this document.