Asia Strategy – A research report on Asian equities and fixed investments in a regional and global context

The theme for the week: Inflation trends, policy decisions and their impact on investors

UCAP Report No. 19 Investing during Inflation, Part I 17/4/2022

The story for investors

The key market belief is that high inflation will cause rates and yields to rise and will impact FI and equities for the rest of 2022 and on to 2023.We fully accept that inflation in **some** economies, especially the US, is of major concern and that **some** central banks will hike aggressively. However this is a very US-centric point of view, which may distort the understanding where the rest of the world is going. The Fed's policy of aggressive hikes contains enough contradictions to cause us to believe that these hikes will end sooner rather than later, and not just because they may hurt the US economy thus causing a Fed U-turn. Our reasoning is based on the belief that the trade -off between rate hikes and falling inflation is lower than the Fed believes, coupled with the relative inelasticity of the some of the inflation drivers to rate hikes, as well as the complications of negative real interest rates and inverted yield curves. Enough said!

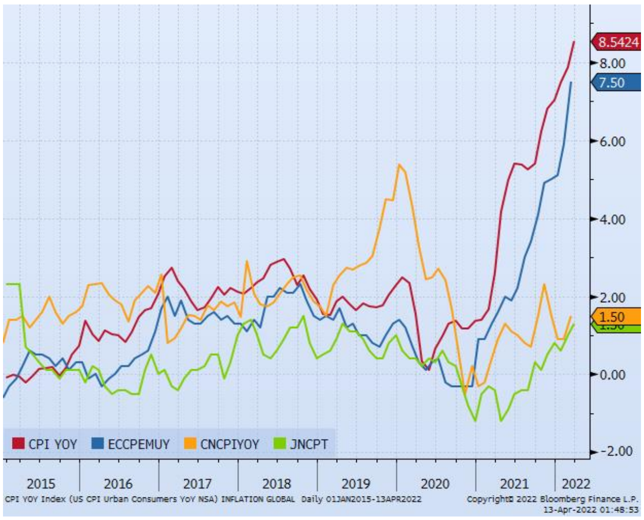
Investment conclusions

USD rates will keep rising at least for the next 6 to 8 months but we expect the Fed to end the hikes sooner than later. We base this expectation on the likelihood that the trade off between higher rates, especially very aggressive ones, a series of 50bps, will not necessarily yield a quick and equivalent drop in inflation to justify this, while the Ukrainian war continues to impact directly and indirectly the world commodities markets. While this plays out, investing in an inflationary world will still be relevant, if nothing else because higher interest rates will be here to stay, although we disagree by how much higher, perhaps a maximum of 175 bps During inflation periods accompanied by higher nominal interest rates banks may do well, as well as investment in real assets, such as property. We return to these issues in Part II of this report.

Not all inflations are the same

China and Japan are not experiencing the sharp inflation rises of the US and EU, and indeed Japan is still keeping its rates very low while China has cut reserve requirements three time since Dec. 2021.The ECB will keep its rates unchanged for now (March 2022). The charts in Fig.1 show the very different CPI trajectories, while those of Fig. 2 show that the drivers of the US and EU CPI inflation are different. In the US Core CPI, which excludes food and energy, is closer to the CPI which does include them, whereas the difference between the EU CPI

Fig. 1 CPI, US (red), EU (blu), China (yel), Jap (gr), 2015-22



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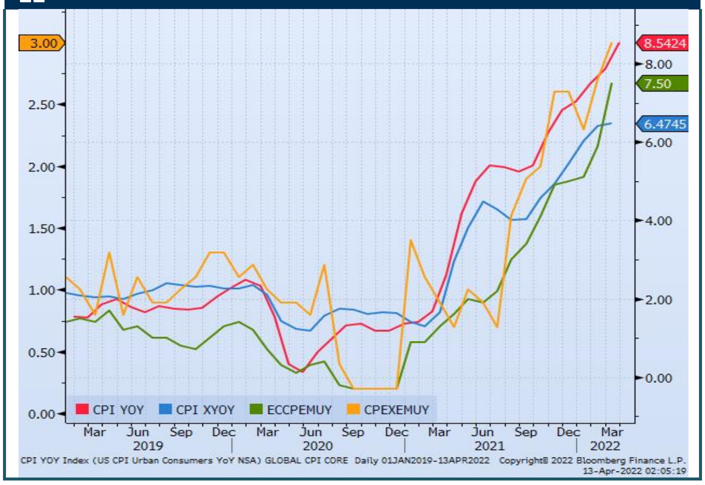
How interest rates affect some inflation drivers

and core CPI is wider, indicating the importance of food and energy in the EU. This raises the question as to how rate hikes would cause the prices of oil, gas, wheat, corn etc to fall thus pushing down the key CPI drivers. There is also the question that since 2008 to date, the prices of assets have increased multifold at the back of lower interest rates. As assets are not included in the CPI, asset inflation remains outside the discussion. Rate hikes, however, have an immediate impact on asset inflation but the link between asset prices and those for milk and shoes is not that obvious!

Fig 2: CPI US (red) EU (gr), Core CPI US (blu), EU (yel), 2015-22



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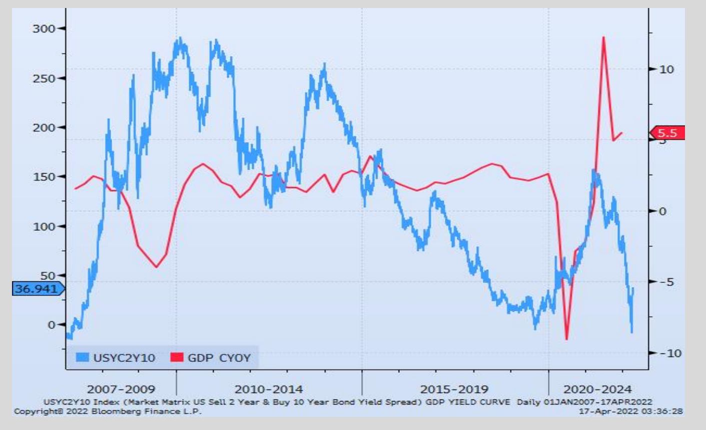
The complex links of real interest rates and inflation

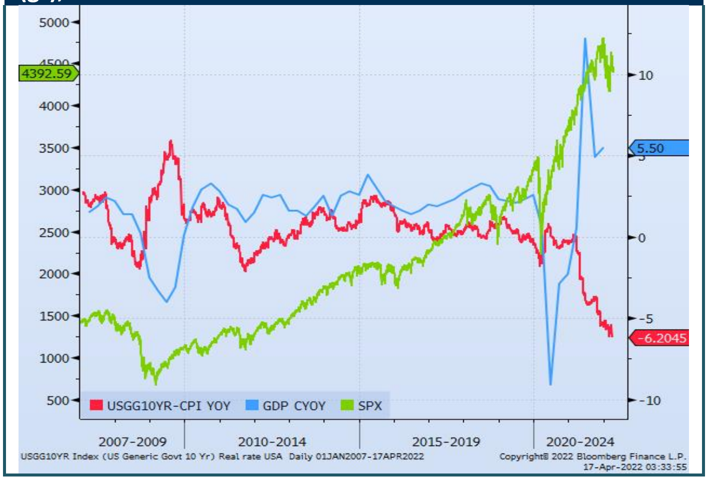
As Fig.3 shows, there is a broad link between real interest rates ,here 10Y US treasuries minus CPI, and longer GDP growth.The reason why real interest rates should match long term GDP growth is based on the expectation that the real economy' s growth will be, in the long run, matched by the real return on the underlying assets driving this growth.There is however no apparent link of real interest rates with the S&P 500, not at at least since 2007 ! Negative real interest encourages borowing as inflation reduces the cost of repayment and interest.Symetrically, the higher the real rates are the less inflation reduces the cost of borowing.The problem with the post 2008 period is, that the zero rates ruling till now, made for very low real rates, and finally negative ones with a consequent disconnect between equities and interest rates.Although negative real rates do not figure in the Fed's estimates, they are clealry the mirror image of the asset inflation since 2008. The Fed is possibly undecided where it wants rates versus inflation, especially if the latter is blamed on a strong economic recovery, and labour market.Long term real rates should match long term real GDP growth.So if the US was to go back to

Fig. 4 The US yield curve (10Y-2Y UST, Blu), GDP (red) 2005-2022



the, roughly historically accurate 2.5% long term GDP growth, this should be matched by a long term real rate of 2.5%.This could be achieved by a variety of combinations of nominal rates and inflation.So the desired Fed rate of inflation at 2.0% would mean nominal rates (here 10Y treasuries) at 4.50% giving a long term real rate of 2.5%.This estimate for the 10Y UST is not a forecast but a historic calcualtion which may help anchor other estimates.But 450bps might partially explain the current concerns of a very high 10Y yields.To make matters more complicated, there is still the link between 10Y yields and the Fed rate.One of the current assumptions is a hike of 7 X 25bps =175 bps.Whether this would lead to a 450 bps 10Y is doubtful especially if inflation falls and leads to readjustment in expecations. The argument is that aggressive25bp or 50bp hikes should be accompanied by equally aggressive declines in inflation to justify them. If the increases in CPI were not caused by factors which can be affected by rates hikes in the US, the Fed will end up with high nominal rates and high inflation, with marginally changed real rates, when what is needed to, supposedly slow down inflation, is higher real rates !

Fig 3: US real interest rates (red), GDP (blu) and S&P 500 (gr), 2007-2022



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Bringing some order to an otherwise chaotic period in the markets

From Fig 4, at first sight there seems to be no convincing evidence that inverted yield curves predict recessions.In any case the evidence will possibly need to extend over several decades rathen than less than two. In general higher long term yields reflect inflation fears, hence a flattening, and finally a truly inverted yield curve (note that truly inverted means 2Y >10Y and not just the curve flattening !) may tell us that long term yields express less concern over inflation and much more about hight short term rates. To summarise our arguements:

First: in the case of the US, nearly 14 years of very low interest rates, bar the period between Dec.2015 to the end of 2018, combined with the outbreak of Covid in 2019 and now with the Ukraine war aggravating inlfation,has removed traditional anchoring points of market exepcations.

Second: the Fed will hike through 2022 to 2023 but we believ not as much as market exepcations and not as aggressive.

Third: the reason for this is the complex interplay of the need to progressively re-establish positive real interest rates, the uncertain reaction of inflation drivers to rate hikes and the psychological rather than real impact of of flat to inverted yeild cruves on GDP growth.

Fourth:investors can expect to make decisions during a period of relatively higher infation than experienced in recent years, but with the prospect of higher but flat rather than rising interest rates later on in 2023.Investment in the banking sector and in real estate may benefit from these developments.

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