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CEO Corner

The Central Banks' illusion of temporary inflation

Daniel Zurbruegg
CEO BFI Infinity

The world today looks very different from the world we knew back in January, when we sent out our last investment update. Our focus back then was on the end of the pandemic and what this meant for the global economy. We identified some of the other problems, including the growing tensions between Russia and the Ukraine, but we did not expect that only a few weeks later a full blown war would break out between the two countries. At the time of writing this, there is still no end in sight, no real hope that the talks getting anywhere close to a peaceful resolution soon.

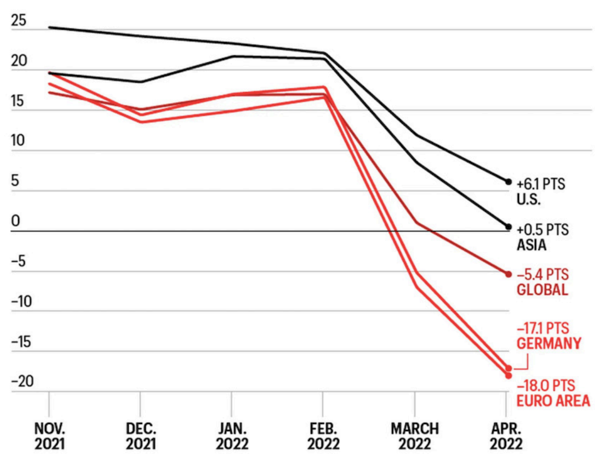
Very quickly after the launch of the Russian offensive, countries around the world, especially in the West, turned against Russia and announced economic sanctions the likes of which we have never seen before against any other country. It seems that this conflict has brought western countries together much more swiftly than we could have imagined. Not too long ago, it looked like Europe and the U.S. would drift further apart, however, the Ukraine war changed everything. And with it, Ukraine has been moving even closer to the West, and especially the European Union, much quicker than we expected. It is clear that Russia and Ukraine will not have much of a future together and it may well be that Russia has created an outcome that is very different from what it originally wanted.

Of course, the war did and continues to create volatility across financial markets. Initially, global equity markets sold off by around 15-20% but have recovered recently and currently major markets are only slightly negative for the year. The biggest impact has been felt in energy and commodity markets with oil prices shooting above USD 100 per barrel. But it's not only energy prices that are on the rise. In fact, most commodities are seeing rising prices. And it is not only due to the war, but probably more linked to the continued problems in the global supply chains. This situation might normalize over time on a higher level, but it will probably still take 6-12 months until prices start to stabilize and only then will we see a dampening effect on inflation.

Consumer prices have risen by more than 5% in Europe over the last twelve months and more than 7% in the U.S., levels that we have not seen in more than 30 years. The pressure on producer prices has been even higher, but as expected, producers are not able to pass all cost increases on to the consumer. This is now creating a completely new macro environment with inflation being much higher and interest rates rising with it as well. US 10-year treasury yields have risen rather dramatically in recent weeks to hit levels of almost 3%, so yields have pretty much doubled since the start of the year. This is already being felt in many ordinary households, with mortgage rates, for example, having jumped very significantly.

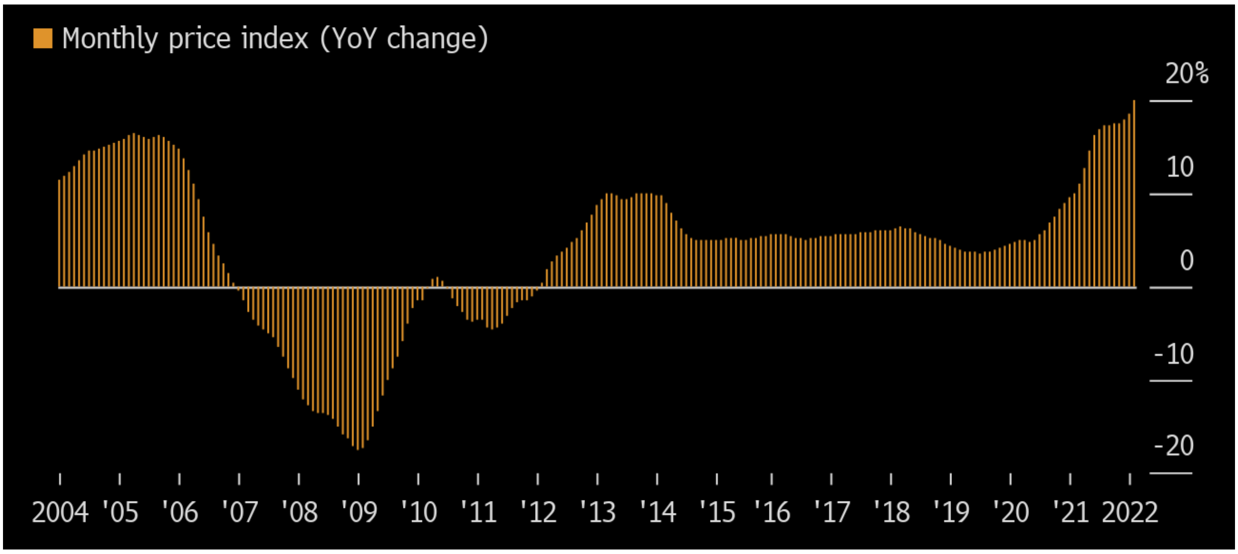
This might not yet cause a dramatic change in the U.S. housing market, since over the last few years, with record low financing rates, most buyers have financed their property purchases with fixed long-term mortgages

Figure 1: Sentix Overall Economic Sentiment



Source: Sentix, Fortune

Figure 2: US Home price growth at a record high



Source: CoreLogic, Bloomberg

at much lower rates. However, going forward, this will certainly cause a slowdown on the housing market with cheap financing options no longer available, at least for now.

With almost 70% of US households living paycheck to paycheck, rising prices will eat into disposable income very quickly. In fact, many households have been seeing their spending budgets come under considerable pressure already in recent weeks.

With this, it should be clear that growth rates will continue to be under pressure, as they have been for months already. The U.S. economy was entering 2022 with a growth rate of around 3% or even slightly higher. According to the Atlanta Federal Reserve, growth has been declining to a pace of around 0.5% in early April, showing a very clear trend. Slowing growth is not only a U.S. problem, as the same is true for Europe and other parts of the world. The IMF and other organizations have therefore started to lower global growth expectations and the current projection of 3.6% global GDP growth for 2022 still might look too high.

Despite the fact that central banks around the world have been providing monetary stimulus for many years, now the situation seems to be changing rather rapidly. With inflation rising quickly, central banks have no other choice than to normalize monetary policy and hike interest rates. Rates are still way too low: if a 10 year treasury yield is around 3% and inflation is around 7%, there is a clear mismatch, so it is no surprise that the market is expecting a series of rate hikes in the coming months. This needs to be done during a time when growth is already slowing and the big question is how long will central banks continue to hike rates before they will need change tack to stimulate the economy again. We foresee a situation when eventually central banks will become more reluctant to hike rates further and such a monetary "U-turn" looks likely to happen in the coming 12 months and its effects will probably be rather strong in financial markets. It would almost certainly cause stock prices and commodity prices to jump and maybe even more importantly, cause the U.S. Dollar to start falling, potentially rather dramatically.

It is crucial to understand that the current macroeconomic environment with inflation being on the rise is not a demand driven situation but rather a supply side driven inflation. Actually, demand globally has been good and stable, but the supply side has not been able to keep up with that. It seems to be almost normal today to experience delays in delivery and shipping of many consumer products, usually because certain parts are not available. This is in sharp contrast to the past decade, when the supply of products was always stable and never a reason for concern. The pandemic has changed it all and we are seeing that the repair of global supply chains is taking

Figure 3: Commodity price boom

Source: Refinitiv, FT

time. Also, it is not only a matter of rebuilding supply chains, but there is also a clear trend away from globalization, as we're switching from global trade to more regional trade. Geopolitical considerations are reinforcing this trend, and this, for example, becomes very visible in the global microchip market, where we see record amounts of new investments to build chip factories in Europe and the U.S. in order to become less dependent on China and Taiwan.

Also, it would be a big mistake to simply assume that things will work themselves out and that inflation will gradually move back to pre-pandemic levels. Investors need to understand that we have entered a new phase, a new era so to speak and as outlined in our Special Report in 2020, things are about to change more permanently. This is particularly true for inflation, where we are now starting to witness a series of self-enforcing dynamics that will make inflation more sticky than previously thought. For example, workers around the world will demand rather steep wage increases to compensate for the lower purchasing power. This will increase costs and create a cascade of price increases. That is why inflation is really problematic if it becomes a longer- term issue. Bringing this under control normally requires painful measures and adjustments and we believe those are yet to be seen.

The world is changing at a rather rapid pace and while globalization is not coming to an end, it is obvious that the world is about to split up into different economic blocks with Europe and the U.S. moving closer together again. The current situation in Ukraine is driving Russia closer to China, at least for now, and for as long as the current political leadership is in control. So we're now facing a more difficult geopolitical situation, more challenging macroeconomics and very likely more volatility in financial markets. This combination creates a very interesting situation for financial markets going forward. Because of these developments a more active investment approach is required, the times when it was enough to buy and hold and let cheap money drive markets higher, are probably over and might not return for a long time.

So, active investment management with an active approach to risk management is now required. This means, as a first step, that investors are required to better diversify their portfolios and that they have to go beyond the traditional bond/stock mix, that is still the case for most private investors. We have for years explained and highlighted the importance of a more sophisticated approach to portfolio construction that not only involves a broader geographical diversification, but also a better diversification among asset classes including alternative investments. That means commodities, precious metals and other alternative investments should be an integral part of a well-constructed portfolio. Also, in view of a potential decline in the U.S. Dollar and the Euro, currency diversification is also a primary consideration going forward.

While we feel that the overall market outlook is more challenging, we continue to see opportunities in selected areas, we just feel that the market environment requires a more focused approach. For example, the recent developments in Europe are offering significant opportunities, as Europe is strongly moving forward to become less energy dependent from Russia (and fossil fuels in general). Also, it is obvious that due to the changing geopolitical situation, European countries are starting to invest in security and defense like they have not been doing for at least 50 years. These two factors alone are going to create an investment boom and we are only at the start of this cycle. There will be big winners from these changes and finding and including these investments in the portfolio is what we are doing for our clients, that is where our passion is.

A final word about gold, since we always get a lot of questions about that: Gold has been moving close to the USD 2'000 mark, in fact it even briefly traded above that a few weeks ago. Readers who have been following our updates in the recent past will remember that we have always had a rather positive outlook for precious metals. This outlook has not changed, in fact it has gotten even more positive. We don't make any precise predictions; we simply feel that the current environment creates a situation where the risk/return outlook for precious metals is heavily skewed to the upside. That is why we stay strongly committed to our investments in this asset class.

Finally, we would like to encourage you to sign up for our current series of webinars called "Fireside Conversations", where we discuss different topics related to investing and economics.

We would like to thank you for your interest in our work and we look forward to receiving your questions and feedback. Please reach out to us if you have any questions, as we are always happy to hear from you and help you in the best way we can. We wish you all a wonderful springtime and send you our best regards from Zurich, Switzerland.

The great "U-turn": What investors can expect in the tightening era

Dirk Steinhoff
Chief Investment Officer

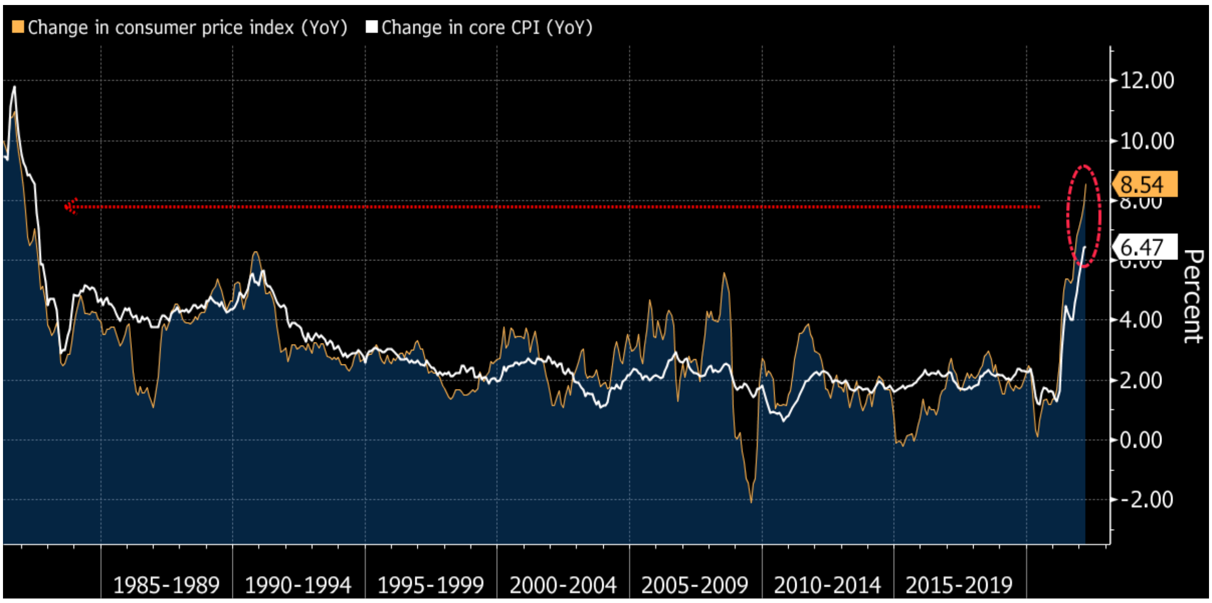
For most investors, the last two years have presented extraordinary challenges, as well as opportunities. Even though central banks had already been pursuing aggressive policies for over a decade, ever since the onset of the pandemic, we entered completely uncharted territories with regard to monetary and fiscal policies and we've witnessed unprecedented measures in response to the covid crisis. And just when we thought it was finally over, most of the world was caught by surprise by the Russian invasion of Ukraine. Apart from the obvious humanitarian tragedy, this new crisis has unleashed a myriad of fresh challenges for the world economy, disrupting trade flow and once again clouding global growth prospects. However, the economic downturn that very likely lies ahead has long been in the making.

Short-term solutions to long-term problems

Despite the narrative that is being so often repeated by politicians and the mainstream financial press, the reality is that inflation is not a new problem. And while the war in Ukraine might have exacerbated it, it most certainly didn't cause it. Higher-than-expected CPI readings have long preceded this latest crisis. Americans and Europeans alike have been feeling these pressures in a very real way for months already, as food prices and energy costs exploded and as wages failed to keep up. In the US, inflation stood already at 7.5% before the conflict broke out. Although President Biden rushed to blame the phenomenon on "Putin's price hike", as he recently put it in a press conference, the US Bureau of Labor Statistics reported in March that over the last twelve months, the all items index rose by 8.5%, the biggest jump since 1981.

In fact, the entire approach to the issue of climbing prices appears to be wholly misguided. Both politi-

Figure 1: US consumer prices post largest annual advance since 1981



Source: Bloomberg

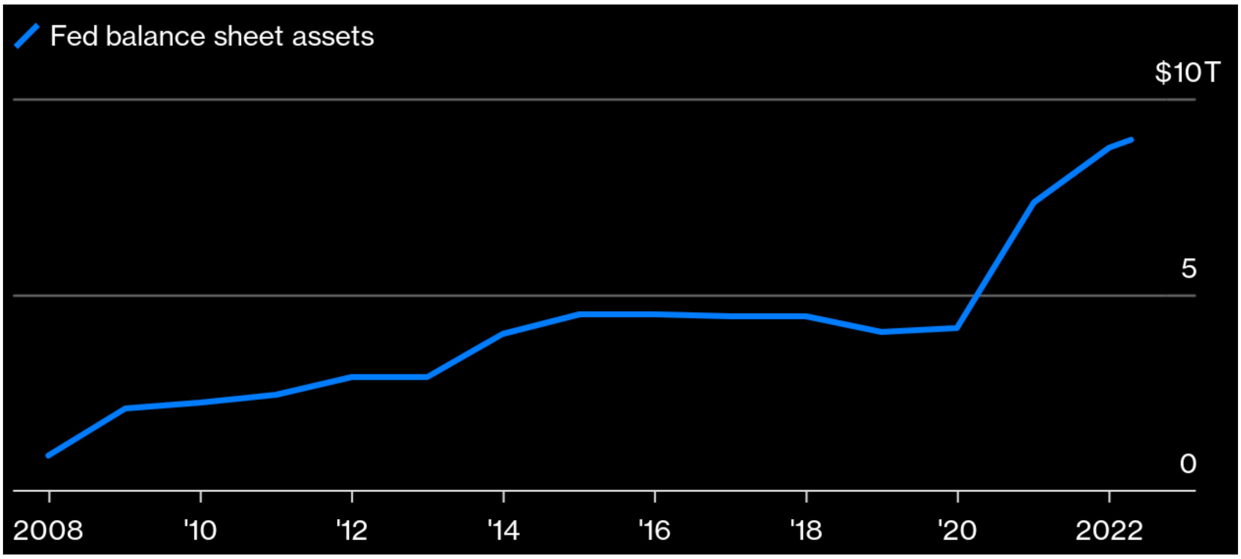
cians and central bankers are trying to tackle inflation as though it were a demand-side problem. This is why we see an increasingly hawkish stance being adopted by the Federal Reserve, pivoting to interest rate hikes and announcing plans to begin shrinking the central bank's balance sheet. Naturally, trying to roll back some of the unprecedented stimulus we saw during the pandemic and attempting to "mop up" some of the excess liquidity is, in principle, a sound idea. However, there are two glaring problems with this "remedy".

For one thing, the enacted rate hike of 0.25% in March (the first since December 2018) and the planned, "aggressive" half-point hikes that are expected to follow in the coming months according to Reuters reports, are very likely to prove insufficient, or "too little too late", to bring inflation under control. What's more, the Fed's plan for the "Great Unwinding" of its $9 trillion balance sheet, is still unclear to say the least. According to recently released minutes from the central bank's March meeting, top officials "generally agreed" on monthly wind downs of about $60 billion for Treasury securities and $35 billion for mortgage-backed securities. Once again, this might not be enough to curb inflation, but it could be more than enough to cause disruptions in the markets, especially if this pace is sustained.

The common denominator of these tightening plans, not just in the US but also in the Eurozone, is that they are targeting the wrong root cause. Unlike many past inflationary periods, this time, we are facing a supply problem and it has been in the pipeline for decades. As we already highlighted in our September 2021 issue of the InSights, this has been abundantly clear in the commodities market. ESG and "green" policies and years of underinvestment in exploration projects have culminated in the extreme shortages we face today and the record-high prices in the energy sector, as well as for copper and other industrial metals. This was a long and slow process and it is unlikely to be swiftly reversed, especially using the wrong tools. If anything, we could expect the situation to worsen, particularly if we factor in the "emergency" measures and "inflation relief" packages we now see from governments all over the world. From fuel tax cuts in the UK and energy subsidies in the Eurozone, to President Biden ordering the unprecedented release of the nation's strategic oil reserves and allowing higher ethanol content in gas, it is clear that the "cures" presented so far are merely political solutions to an economic problem.

The high prices for commodities reflect an imbalance of supply and demand. And, we pointed out out before, it is now not the demand side, but the

Figure 2: The Federal Reserve's balance sheet expansion



Source: Bloomberg

Figure 3: Global Money Supply (GLMOSUPP Index) vs MSCI World Index (MXWO)

Source: Bloomberg

supply side that is driving prices higher. Therefore, trying to solve a supply-side problem by further stimulating demand is clearly counterproductive. To bring prices down, either supply must be increased and/or demand must be curbed. However, the supply of raw materials cannot be increased at the push of a button. Years or decades can pass between the "discovery" of new deposits and their extraction or mining.

A rough roadmap

One of the most important things that we feel investors must keep in mind going forward is that (at least) since the 2008 recession, stock markets have not been primarily driven by fundamentals, but by central bank policies. This is especially crucial now, as we stand on the verge of a great "U-turn" in these policies. After more than a decade of Quantitative Easing (QE) and ultra-low interest rates that fueled the record highs of equity markets, inflation is now finally forcing central banks to reverse their course. While it remains doubtful whether this pivot will have a meaningful impact on inflation and even if so, if it will come in time, there is a very strong possibility that it could cause serious turbulence in the markets and in the economy at large.

Specifically in the US, the Fed has been so far entirely focused on the second part of its "dual mandate" of "price stability and maximum sustainable employment", in order to support the economy and the financial markets. This arguably came at the expense of price stability, which the central bank is now trying to control. With unemployment at record lows, inflationary pressures have now become more than just an economic challenge. With the midterm elections fast approaching, growing public discontent over climbing prices is emerging as a key political issue too, pilling on the pressure on the government and the Fed to take action, even if it is realistically insufficient.

We therefore expect the central bank to commit to this policy U-turn and to keep pursuing its price stability goal through QT and rate hikes, despite the risks this will pose for the markets and the economy. However, we believe these risks to be severe, given the "addiction" that stock markets in particular have developed to easing policies over the years. Additionally, the extreme corporate debt levels that the zero interest environment has encouraged will likely become very problematic should the Fed stick to its planned rate hikes. The same can be said of consumer borrowing, which in February surged in the US by the most on record, a $41.8 billion jump from the month before. Overall, this tighter monetary policy direction is bound to put dangerous pressure on an economy that is rife with structural vulnerabilities and has had barely any time to recover from the unprecedented restrictions and disruptions of the pandemic.

As a result, the Fed's tightening "U-turn" and the current focus on one part (price stability) of its mandate, will very likely lead to a deterioration in the second (the economic situation): as the economy slows down and eventually probably sinks into a recession, unemployment will once again emerge as the most urgent problem, forcing policy makers to perform yet another "U-turn". Whether inflation will actually have been tamed by then, and to what extent, is highly debatable, but it will also be beside the point. At that stage, supporting the economy and the workforce will once more become the priority and a full return to QE and to low interest rates can be expected.

Investment implications

While we do expect a significant slowdown, and quite possibly even a recession, once this policy shift toward tightening really begins to have an impact on the real economy, it is practically impossible to predict its precise timing. We could start seeing indicators pointing to a recession even before the end of this year, but what is a lot more certain is that higher stock market volatility levels will characterize the next weeks and months.

We therefore believe that it is imperative for investors to understand that the coming quarters will not be fit for "buy and hold" strategies and will require great vigilance, agility and downside protection. Even if we are surprised by positive developments, such as a swift resolution to the Ukraine crisis, which would probably fuel a "relief rally", we can expect this to be rather short-lived. As long as the inflationary pressures remain unchanged and as long as central banks retain their monetary tightening stance, stock markets will have a very hard time sustaining a rally or indeed the current levels.

Of course, none of this means that investors should turn their backs on equities. During this tightening period, we expect traditional defensive sectors to present good opportunities, while commodities could also offer an inflationary hedge, in the likely scenario that the central banks' efforts will prove inadequate in controlling climbing prices.

Most importantly, however, we anticipate a roaring rally in stock markets once that second "U-turn" (the "U-turn" from the "U-turn") is becoming apparent and once we return to the path of QE and we will see, most probably, massive fiscal stimulus. In the course of this development, the USD is also bound to suffer as the credibility of the Fed will be adversely impacted, while the overall political and economic climate will be likely be quite negative too, both factors being supportive of a strong performance for gold.

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BFI Infinity Inc.

Zurich Office:
Bergstrasse 21
8044 Zurich
Switzerland

Tel. +41 58 806 2210
Fax +41 58 806 2211
advisors@bfiwealth.com
www.bfiwealth.com