MAERKI BAUMANN & CO. AG

PRIVATBANK

Underestimated inflation debate?

Market Comment, September 2020

Over the course of time, the market focuses on various themes, depending on what is making the headlines at any particular time. One market theme that has recently receded into the background somewhat is inflation. Part of our investment strategy approach involves analysing themes that are not the current focus of attention, as these may be underestimated. One issue that could become more prominent over the next few months is the debate over inflation, particularly in the event of economic data improving. In such a scenario, the emphasis could shift from sovereign bonds more to their corporate counterparts.

Given the slump in economic output this year due to the proliferation of coronavirus, the world's leading central banks have had to embark on a path of huge monetary policy stimulus to support the economy. Sooner or later this could trigger an inflation debate:

Will such an enormous ballooning of central bank balance sheets have the effect of increasing inflation in the long term? Might we not end up (thanks to the flood of liquidity unleashed by central banks) in a situation of too much money "chasing" too few goods? If demand rises very sharply again, might this not lead to price increases, i.e. inflation by any other name?

A look back at the recent past could prove useful. Following the collapse of Lehman Brothers in September 2008, the US central bank (Fed) flooded the financial markets and the economy with enormous liquidity. By the spring of 2020, this had increased the so-called "base money supply" – including the reserves of the commercial banks held with the Fed – by some 12% a year; the Fed's total balance sheet assets rose by some 660%. However, US inflation over the same period only worked out at an average of some 1.6% a year. According to conventional monetary theory, a dramatic monetary expansion or flood of liquidity such as that initiated by the Fed from 2008 onward in the form of its quantitative easing (QE) programme should have led to a much stronger inflation. Expansion of the money supply and higher inflation need not exhibit a 100% correlation, as there are a number of other factors that influence the development of inflation. Statistical analyses have shown that increases in the supply of money often correlate more with earlier rates of inflation than they do with future inflation. It should also not be forgotten that while a central bank may control the base money supply, it cannot control the overall volume of money in circulation. The total money supply is controlled by all the various economic players in the monetary system. These participants may increase or reduce their bank deposits at any time, while for its part the Fed, for example, can influence the reserves of the commercial banks through the purchase of their securities.

> "The inflation debate can be expected to intensify over the next few quarters."
>
> Gérard Piasko, Chief Investment Officer

What makes the difference here is known as the "money multiplier". This means that in any given country the population can influence the monetary policy of their central bank one way or the other through changes in the level of bank deposits. For this reason, there may be differences between the development of financial markets (rising equity and bond prices) and that of the real economy. As it happens, the money multiplier has actually declined sharply since 2008 – just as it has once again in recent months. Indeed, one could even say that central banks realize that – because the population is adopting such a cautious stance in respect of the money multiplier – even greater liquidity than before has to be released: on the one hand to combat the problem of low inflation (i.e. risks of deflation), and on the other to increase economic growth, which is modest when judged by historical standards. The fact that US Fed Chair Jerome Powell recently let it be known – at the annual symposium of central banks in Jackson Hole – that the Fed would tolerate inflation overshooting its target [of 2%] confirms our view that key interest rates in the US are likely to remain at their current record lows for quite some time. For example, the recent rise in the US "personal saving rate" shows us how cautiously households are responding to the current situation. Given this background, the unprecedented release of liquidity by the central bank is justifiable.

The recent wave of banking regulation has also pressed down on this money multiplier, thereby requiring central banks to adopt an even more expansionary stance: In phases of economic uncertainty, credit risks rise. The result of the wave of more rigorous regulation rolled out since 2008 is that banks are now permitted to hold fewer high-risk assets, hence their balance sheets tend to be made up of a higher proportion of government bonds (and in many cases fewer loans). It would not surprise us if central banks were to continue to struggle to bring inflation in at the desired level of just under 2%. As pointed out earlier, even in the US inflation has averaged only around 1.6% a year since 2008. That said, there are a number of reasons for thinking that inflation is currently being somewhat underestimated by the markets, and that greater volatility could become apparent in the government bond market as a result:

1. Although the recession of 2020 may be more severe than that of the financial crisis, a recovery should also manifest itself more quickly thanks to the record levels of economic stimulus.
2. Central banks currently appear to be willing to accept higher rates of inflation, as this has turned out to be lower than expected in recent years.
3. In the US in particular, rising social inequality is leading to a rise in minimum wages and wage costs, as the need to combat social inequality at the political level is set to become more important – particularly in the event of the Democrats proving victorious in the US elections in November 2020.
4. Governments will provide additional economic stimulus through fiscal measures and thereby increase their budget deficits. This could weigh on government bonds.

Conclusion: There is no real debate over inflation going on right now, but that could be set to change over the next few months or quarters. This in turn could lead institutional investors to increasingly switch from government bonds to corporate bonds.

Gérard Piasko

Gérard Piasko is CIO and head of the investment committee of private bank Maerki Baumann & Co. AG. Before he was for many years CIO of Julius Baer, Sal. Oppenheim and Deutsche Bank.

Modular investments with Maerki Baumann

The topics of the current market comment concern tollowing focus modules:

Equities Switzerland	Equities USA	Bonds CHF	Global Balanced
Small & Mid Caps Switzerland	Equities Emerging Markets	Bonds EUR	Commodities
Equities Eurozone	Equities Global Impact	Bonds USD	
Equities Germany		Bonds Emerging Markets	

Please contact your client advisor for further information or visit our website.
www.maerki-baumann.ch/modular-investments

Editorial deadline: 10 September 2020

Maerki Baumann & Co. AG
Dreikönigstrasse 6, CH-8002 Zurich
T +41 44 286 25 25, info@maerki-baumann.ch
www.maerki-baumann.ch