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Monthly Update – November 2020

As at 27 October 2020

Summary

- The current developments seen in the global economy and financial markets are increasingly being characterised by a "reflation of the system". The extremely loose monetary policy from central banks has led to a combination of slightly higher inflation expectations, greater consumption of goods and stronger economic growth. Added to this is a move towards higher long-term interest rates.
- However, these developments are moderate and fairly controlled. We do not currently see any exaggerations or outliers as a consequence. Overall, this creates a favourable environment for financial markets, as both monetary and economic drivers remain in balance.
- Central banks around the world are deliberately pursuing reflation and this is likely to continue for some time to come. The associated higher inflation rates, falling dollar exchange rates and rising interest rates are therefore tolerated by central banks, and do not pose a problem for financial markets for the time being. Reflation even benefits stock markets over the medium term, as consumption is being encouraged and the yield curve steepens. This will help support corporate profits.
- However, these positive effects are increasingly offset by the current second global Covid-19 wave. This development is now at a critical juncture and could quickly lead to a severe economic slowdown. The upcoming US presidential election also serves to cause additional uncertainty.
- Various short-term financial market indicators are currently still positive, reflecting the successful reflation that has taken place so far. However, a possible collapse at any time cannot be ruled out, as the impact of the escalating pandemic cannot be accurately assessed. The situation is comparable to February, when the consequences of the pandemic were ignored by markets for a long time, which then led to a sharp drop.
- We therefore remain neutrally positioned until a flattening of daily infection numbers becomes apparent. This could very well happen within the next two weeks. By then, the US presidential elections will have already taken place.

Highlights and key changes

- "Reflation" aims at a controlled and limited increase in the price level through expansionary monetary policy. This encourages consumption and investment, as purchasing and investment decisions tend to be brought forward to benefit from the current low price level. Simultaneously, wages remain stable or rise slightly, which has an additional positive economic effect.
- Since the Financial Crisis, which ended in 2008, central banks have been trying to trigger a moderate reflationary trend. They have so far, however, only achieved modest success and inflation rates across many regions remain below target levels. Nevertheless, with the extreme monetary and fiscal stimulus packages seen in recent months due to Covid-19, successful reflation seems increasingly likely – at least in the US. Various indicators (e.g. the labour market, housing construction, consumer spending, inflation expectations, yield curve dynamics and the US dollar) all currently confirm that there is a growing reflationary trend.
- As long as the trend remains controlled, the environment for financial markets that is emerging is ideal. It is being supported by a balanced combination of economic growth, the increasing consumption of goods and continued loose monetary policy. Higher long-term interest rates and a steeper yield curve are a positive confirmation of this development.
- A danger to financial markets over the medium term would only appear if there is stronger acceleration in growth and inflation, and a further weakening of the US dollar. In this case, central banks will have to step on the brakes and halt the upswing. At present, this is not the scenario we are in.
- The diminishing momentum of money supply dynamics that has been observed worldwide for some time is beginning to slowly turn around again. For example, the balance sheet of the Fed, after several months of stagnation, is now starting to increase slightly. It is possible that the Fed is already reacting ahead of the negative effects of a second wave of Covid-19. Although this would generally weaken the US dollar, this is not an issue for them at the moment. On the contrary, it will enable other central banks to become more expansionary. Globally, an extremely strong supply of liquidity is therefore assured. At the same time, there will be further fiscal policy stimulus in the future.
- The strong second Covid-19 wave is increasingly becoming an unpredictable killjoy. The development is extremely dangerous and could get out of control. However, there are some rays of hope:
 - The introduction of vaccines as early as December is becoming increasingly likely. Phase III trials have been completed and approvals are approaching.
 - A comparison with the Spanish flu of 1918/1919 shows that there was also a strong second wave in the Autumn of 1918, where it peaked at the end of October, when there was also a lack of vaccines.
 - Death rates remain at low levels in most countries. Two effective drugs and improved treatment methods are already in use. In addition, new and promising antibody drugs can be expected in the foreseeable future.
 - Israel weathered the second wave (with almost 10,000 infections per day) a month ago. However, similar measures to Israel's have also been taken in a number of other countries. The positive effects should become evident in the near future.

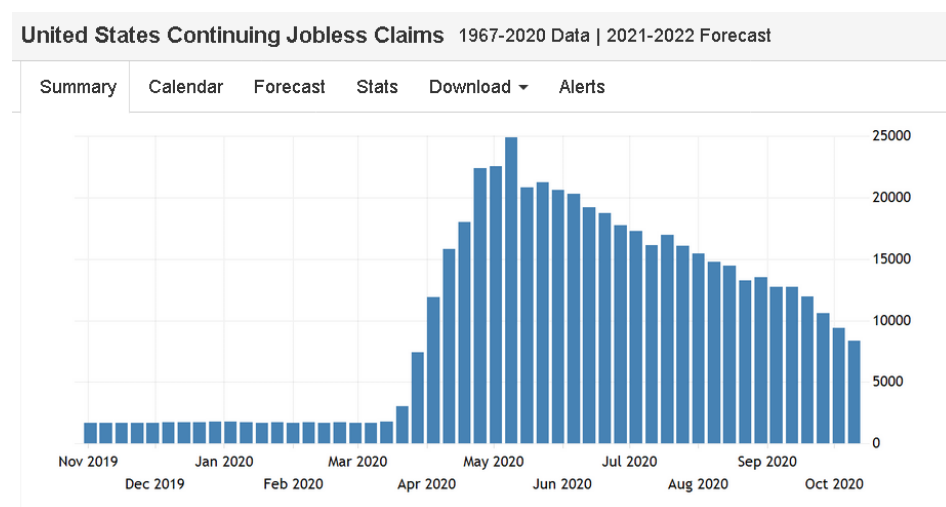
- Various economic and market indicators (money supply, market breadth and the reaction to news) still confirm the positive environment we are in that has been triggered by reflation. Market liquidity meanwhile, remains plentiful.
- In addition, financial market valuations are in neutral territory given the low interest rates. For example, dividend yields are still around 1.8 percentage points above money market rates, which has historically represented a large risk premium. We are not currently seeing any major exaggerations in credit markets either. There are even some interesting investment opportunities to be found in various emerging markets. One exception is government bond markets, which are expensive and are under pressure from slightly higher inflation expectations. However, positive forces are still at work at present, which will dampen any rise in interest rates.
- Despite this overall favourable current environment, we remain neutrally positioned until there is more clarity on further developments related to the Covid-19 pandemic and the US presidential elections.

Topics “on the radar”

The economic recovery in the US has continued at a steady pace in recent weeks. The labour market in particular has improved significantly. The meaningful "continuing jobless claims" (the number of people receiving unemployment benefits) has reached 8.4 million, as Chart 1 shows, after a peak at 25 million in May.

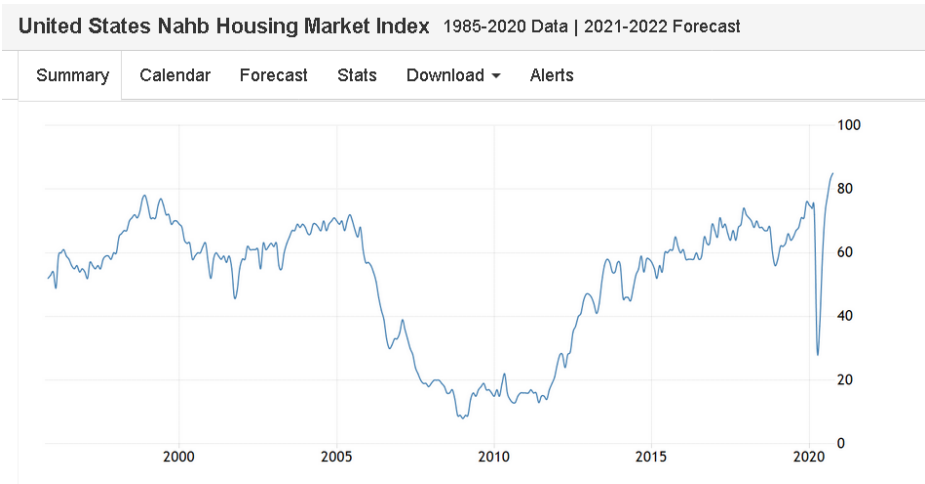
These are weekly data and it appears that the number of Covid-19 cases, which have been rising again for some time, have not yet had a negative impact on the US economy. This may change at any time, but so far this behaviour is surprisingly positive. The US housing market, which is important for consumer confidence, is also extremely robust (see chart 2).

Chart 1: US labour market recovers strongly and steadily



Source TradingEconomics

Chart 2: US housing market also very robust



Source [TradingEconomics](#)

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