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Monthly Update – August 2021

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Summary: Loose monetary policy remains dominant factor

- **Inflation rates in the US and Europe have edged significantly higher, but momentum in the US is falling again – expectations remain moderate and controlled**
- **Central banks continue to confirm loose monetary policy, despite higher inflation**
- **We are seeing a slight easing of the previous restrictive monetary policy in China**
- **Global economic momentum is now continuing to decline slightly**
- **The US labour market remains a decisive factor in determining monetary policy**
- **Continued skilful communication by the Fed: discussion of tapering of securities purchases has begun, and is already being priced into markets.**
- **The environment for financial markets is balanced with no evidence of exaggerations**
- **Equity markets are highly valued and upside potential is limited – there is little upward pressure on interest rates for the time being, but potential surprises cannot be ruled out in the medium term**

Significant changes compared to the previous month

- Inflation rates are currently rising significantly in the US and the eurozone, and are slightly above expectations. However, the inflation momentum in the US is already waning. The monthly values in July are below those of the previous months. Thus, the situation remains under control for the time being.
- What is striking is that inflation expectations remain very moderate. Market participants and consumers trust the statements of the central banks and expect only a temporary increase in inflation.
- The global economic slowdown continues, especially in China. So far, however, this has not put any significant pressure on corporate profits.
- Bond markets around the world are reacting accordingly with stable to falling long-term yields.

— In this environment, central banks are continuing their extremely loose monetary policy. The Chinese central bank (PBoC) is also beginning to ease moderately from its earlier restrictive course.

— Accordingly, we expect continued strong monetary tailwinds for equity and credit markets, but this is partially offset by high valuations.

— Real estate markets continue to accelerate globally. Overheating combined with stronger labour markets could lead to tighter monetary policy in the medium term.

Current situation and positioning

— A continuing slight cooling of the global economy with concurrently moderate inflation expectations allow central banks to continue, or even further loosen, their extremely loose monetary policy without any great risk of overheating.

— In China in particular, the latest economic data point to a weakening trend. This allows the PBoC to ease its restrictive monetary policy somewhat, which has been in place for several months. This is of great global relevance, as it supports the US dollar and makes it easier for the Fed and the ECB to independently implement their own monetary policies.

— This combination of reduced demand for money due to lower growth and simultaneously increasing liquidity supply is creating high excess liquidity in financial markets. Some of this money flows into the equity and credit markets, providing solid support and offsetting high valuations. Another part of the liquidity continues to be parked in the repo and money markets, providing a reserve in case of higher demand for money. Overall, this stabilises and balances the financial system.

— The high excess liquidity also supports commodity prices. However, no sharp increase is to be expected here, as the aforementioned loss of momentum in global economic development is having a dampening effect on prices.

— Inflation rates are currently rising strongly worldwide. However, part of this is explained by base effects, which will fade out again in the coming months. At the same time, lower economic growth will dampen inflationary pressures over the next few months. In the US, the rate of increase in inflation is already weakening once more, even though the absolute level remains high.

— Financial markets therefore continue to trust the central banks' statements that this is currently only a temporary increase in inflation. This also increases the confidence of market participants in monetary policy, which is currently being communicated in a very skilful and market-friendly manner. The tapering of securities purchases is already being discussed and should not trigger any major surprises once implemented.

— In this environment, there is little short-term pressure for rising long-term interest rates. However, the interest rate level should be much higher due to the expected medium-term growth rates of the economy and inflation. There is thus a large divergence between the current interest rate level and the expected values implied by fundamentals. This can lead to a surprise interest rate adjustment at any time.

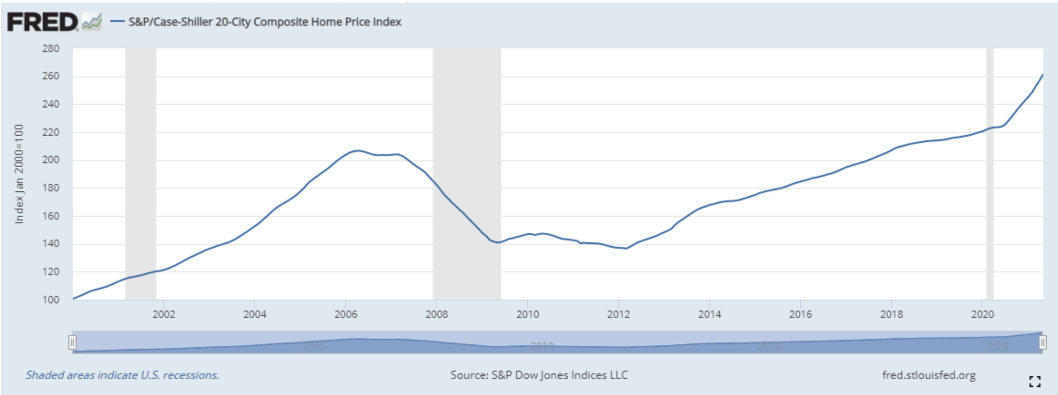
— The positive effect of the loose monetary policy is also still dominating equity and credit markets for the time being. This partly justifies the high valuation levels. In the medium term, however, we expect lower corporate profits due to the economic slowdown.

— Accordingly, we assess the upside potential on the financial markets as intact but limited. The current trends are not very pronounced and are susceptible to disruptions.

— One possible disruptive factor in the future could be the further sharp rise in real estate prices worldwide (see "Topics on the radar" below), which makes it difficult to maintain loose monetary policy. However, as long as labour markets, especially in the US, do not accelerate significantly, property price increases are not yet an immediate threat. Thus, the labour market remains the key factor in determining future monetary policy, and thus financial market momentum.

Topics “on the radar”

Chart: Real estate markets worldwide are showing strong price increases



Source Federal Reserve Bank of St. Louis

House prices are currently rising steeply and at an accelerated pace in the US. The chart shows the Case-Shiller 20-City Composite Index. Other indices confirm this picture. The current movement is even stronger than in the years 2004 to 2006 in the run-up to the financial crisis.

It is furthermore a worldwide development that is a consequence of the extremely loose global monetary policy. We therefore expect this movement to continue to strengthen and to be a long-term trend that will become difficult to dampen.

Rising house prices, together with prevailing high consumer spending, are strong potential drivers of future inflation. The US central bank is watching developments closely and will have to take initial measures in the foreseeable future. A reduction (tapering) of MBS security purchases (QE) is being discussed. However, this measure should only have a moderate impact on real estate prices.

However, as long as the US labour market does not pick up more significantly, monetary policy is not expected to come under any major pressure in the short term. Nevertheless, in the medium term, a serious potential danger for financial markets and the development of interest rates is building up.

Summary of *FischView* model outputs

	US	Europe	Japan	Asia ex-Japan	LatAm	CEEMEA
Equities	+	+	+	+	+	o
Government Bonds	-	-	-			
Credit IG	o	o		o	o	o
Credit HY	o	o		o	o	o
Convertibles	+	+	o	+		

Commodities	Energy	+	PrecMet	+	InduMet	+

Key:

++	Strong positive
+	Positive
o	Neutral
-	Negative
--	Strong negative

Notes regarding the table: Changes from prior month are indicated with ↓ or ↑. i.e. "O ↓" means that the output has weakened from a prior value of + or ++.
The methodology for calculating model outputs, and how the various pieces fit together to form the big picture, is explained **here**.
Within government bonds, we consider the most important bonds for each region, e.g. German Bunds in Europe, and a representative group of countries for Latin America, Asia ex-Japan and CEEMEA (Central and Eastern Europe, Middle East and Africa).

Cross asset class preferences

This table combines top-down views with bottom-up analysis at the portfolio level.

	Most preferred	Least preferred
Convertible Bonds	– Cyclicals (industrials, materials)	– Interest rate sensitives (real estate)
Global IG Corporates	– USD IG – Spread duration 5-10 – “Rising Stars”	– EUR IG – Spread duration >10 – Utility and real estate
Global Corporates	– Developed market HY – Spread duration 5-10 – ‘BB’ rating segment	– Emerging market HY – Spread duration >10 – ‘B’ rating segment
Global High Yield	– ‘B’ rating segment – Telecoms – Basic industry – Energy	– Banking – Transportation – Real estate, especially China
Emerging Market Corporates - Defensive	– Indonesia – Mexico	– South Korea – Taiwan
Emerging Market Corporates - Opportunistic	– High yield commodities – Mexico	– Bahrain – Qatar

Note: Preferred sectors/regions may differ between asset classes owing to respective performance drivers. In particular, equity exposure is the key performance driver for convertible bonds and is not relevant for corporate bonds.

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