Review of the 3rd quarter 2021 and outlook

What climate change, empty supermarket shelves in the UK and the ketchup bottle effect can tell us about future inflation

"Nothing comes for a long time, then suddenly everything at once"

Probably all of us have experienced the ketchup-bottle effect in different situations - not only in the unsuccessful attempt to "enhance" the taste of a dish. Incidentally, the complex diffusion behaviour of liquids such as ketchup was first researched by the Austrian physicist Karl Weissenberg (1893 - 1976) and is important for technical and scientific applications.

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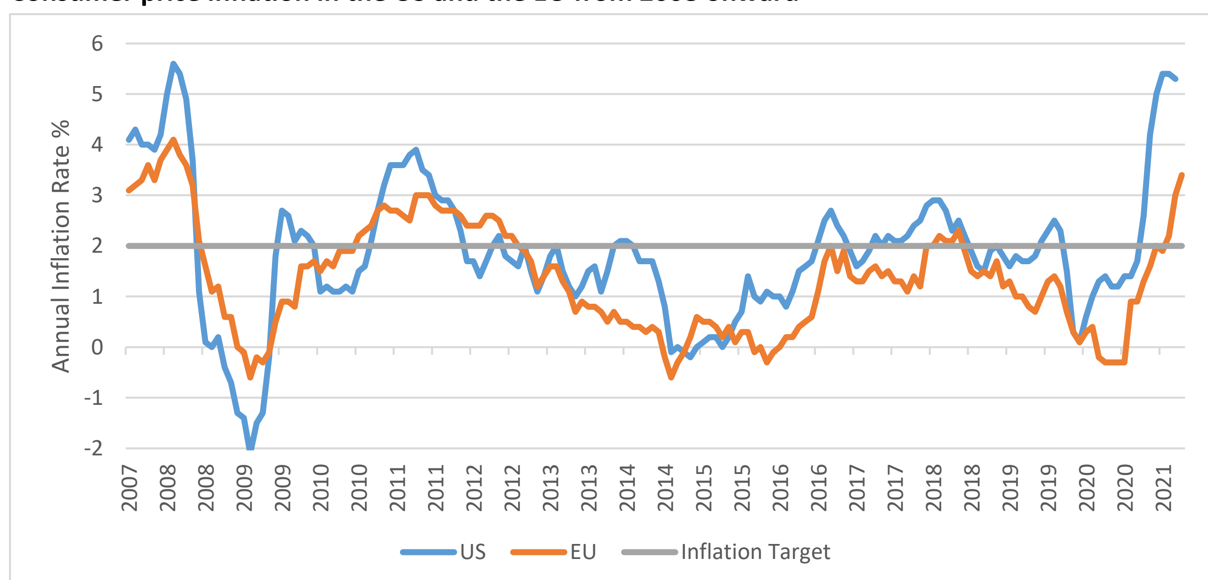
Anyone who has been involved with financial markets and central bank policy for some time knows the efforts the major central banks have made to try to generate an economically healthy level of inflation after the financial crisis of 2008/2009. Both the US Federal Reserve and the European Central Bank ECB have been aiming for an annual inflation rate of 2% for a considerable time. This rate is generally considered to be a good compromise between relative price stability and a rise in prices that stimulates consumption and investment. Both central banks, but especially the ECB, have mostly fallen short of this inflation target during this period:

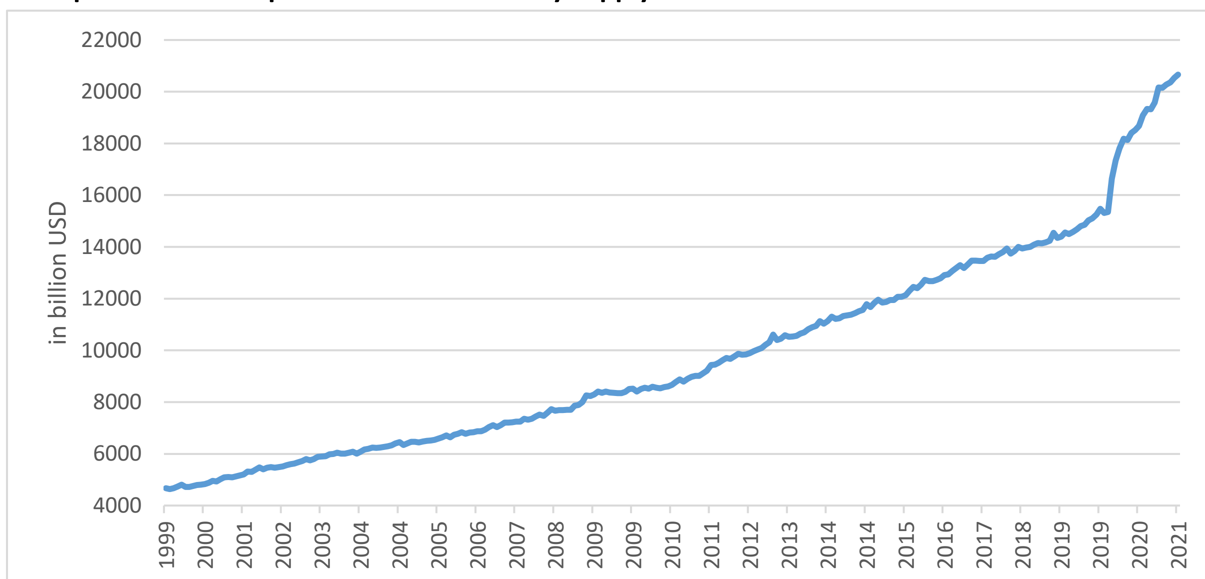
Consumer price inflation in the US and the EU from 2008 onward



Source: Bloomberg

To stay with the image of the ketchup bottle: The central banks hit the bottom of the bottle vigorously and persistently, but the ketchup jammed in the neck of the bottle due to its special flow property and only very little of it made it to the plate. It was only with the massive fiscal and monetary "hits" by governments and central banks from Q2 2020 onwards (the huge stimulus and aid programmes introduced worldwide in the wake of the Corona pandemic) that the backlog in the ketchup bottle seems to have been released. However, this has resulted in significantly more ketchup (= inflation) coming out of the bottle than is desirable (and seems advisable for a healthy diet) since about May 2021.

Example USA: Development of the M2 money supply since 2000



Source: Bloomberg

Inflation: only temporary effects or "here to stay" after all?

If one follows the numerous statements and pronouncements of the central banks on the recent jumps in inflation, it is repeatedly pointed out that this is a temporary development that does not constitute a reason for decisive monetary policy action such as the reduction or termination of bond purchase programmes or even key interest rate hikes.

The attitude of the central banks is increasingly being viewed critically on the financial markets. The prevailing concern is that they are waiting too long to reduce the supply of liquidity and that the dynamic rise in inflation will ultimately become uncontrollable. The central banks' main argument for their restraint, statistical base effects from the sharp declines in inflation rates in 2020, is actually limited in time, however. Above all, they are also based on the extremely low energy and commodity prices in the past year.

In the meantime, we see a number of inflationary influences whose temporal extent cannot be predicted well and which seem to us to be capable of having a strong effect on inflation for a longer period of time. We would like to illustrate this with a few examples:

Political decisions, such as the BREXIT or the new excessive spending programmes of the US government, often have a delayed effect. Empty supermarket shelves and hoarding of fuel in the UK are only to a small extent due to the Corona pandemic, even if the government likes to portray it differently. In the meanwhile, the consequences of the restrictive immigration policy after leaving the EU are having a very clear impact as an acute disruption of the British labour market. For example, the departure of tens of thousands of workers, mainly from Eastern European countries, has left painful gaps in the logistics sector or the food industry, which are only now entering the public consciousness with a time lag and with great force. The cause "BREXIT" is a specifically British problem. However, the demographic development of most major industrialised countries with an ageing population and far too few younger workers to fill it already foreshadows the gaps that will arise in the future. A massive shortage of labour will never be without consequences for wage costs, which are still considered the most effective trigger of a persistent inflation trend (keyword: "wage-price spiral").

Climate change and natural disasters are increasingly showing their economic consequences. Brazil, for example, is currently experiencing the impact of extreme weather changes and reckless use of natural resources on the country's agricultural economy. Wildfires, extreme drought and, last but not least, an Antarctic weather front that forced parts of the country under a thick layer of frost destroyed significant parts of the expected harvests. The drying up of rivers and lakes, in turn, additionally leads to severe disruptions in the energy supply from hydropower plants, with which Brazil covers more than 60 % of its electricity needs. To fully grasp the global significance, it should be mentioned that Brazil, for example, exports three quarters of the orange juice consumed worldwide, half of the sugar, one third of the green coffee and about one third of the feed for animal breeding. Supply shortfalls of such magnitude are not easy to compensate for on the world market, so we can safely assume that we will inevitably see further increases in food prices due to shortages at all stages of processing and trade.

Disruptions in supply chains. In our review of the first quarter of 2021, we already addressed the far-reaching consequences of small disruptions in international supply relationships and their consequences using the example of the container ship that became stranded in the Suez Canal. In the meantime, the disruptions emanating from a wide variety of causes (regional lockdowns due to recent Covid-19 outbreaks, empty stockpiles, lack of truck drivers) are reflected in the absence of a large number of very different imported products or of energy (natural gas) and various raw materials. Whether it is lumber, clothing or semiconductors, importers, even if they can actually get their goods somewhere at (usually high) prices, often have an additional transport problem. For example, the extreme shortage of containers, shipping space and port capacity has now led to freight rates from China to Europe being about eight times higher than the long-term average and more than doubling since April alone. We consider the passing on of higher producer prices (now often in the double-digit percentage range) to end consumers to be a fairly safe assumption in the current situation.

Consumer prices will continue to rise - even against the will of the central banks

We are bracing ourselves for higher inflation rates to prove more durable than is officially expected in central bank circles. In all likelihood, central banks will continue their tightrope walk and continue to manoeuvre between a monetary policy oriented towards appropriate price stability and their unofficial secondary objective of securing the huge money requirements of states and public budgets with the most favourable financing conditions possible.

While the European Central Bank continues to stoically try to calm inflation concerns by referring to temporary effects, at least the US Federal Reserve recently indicated its willingness to face reality in the foreseeable future. There are increasing signals that a cautious reduction of bond purchases in the US dollar area will probably start at the beginning of 2022. This should not yet be confused with a real departure from the long-standing low interest rate policy (or with a decisive fight against inflation), but will merely slow down the increase in the money supply through reduced liquidity supply.

Nevertheless, we have to expect that such a change of direction, as on previous occasions, and not only with regard to investments in US dollars, will lead to significantly increased nervousness on the financial markets.

Fixed-interest investments continue to play no significant role in our portfolio design. In addition to their lack of attractiveness due to mostly negative real yields, the threat of price losses in the event of rising nominal interest rates also keeps us from investing in bonds beyond an absolutely necessary level. Stock markets will initially have difficulties with the expectation of rising interest rates for valuation reasons (lower present values of future profits due to higher interest rates). Greater volatility is likely to be the result. Alternative forms of investment or special equity strategies, which have a special focus on limiting downside risks, thus take on even greater importance.

Review of the third quarter

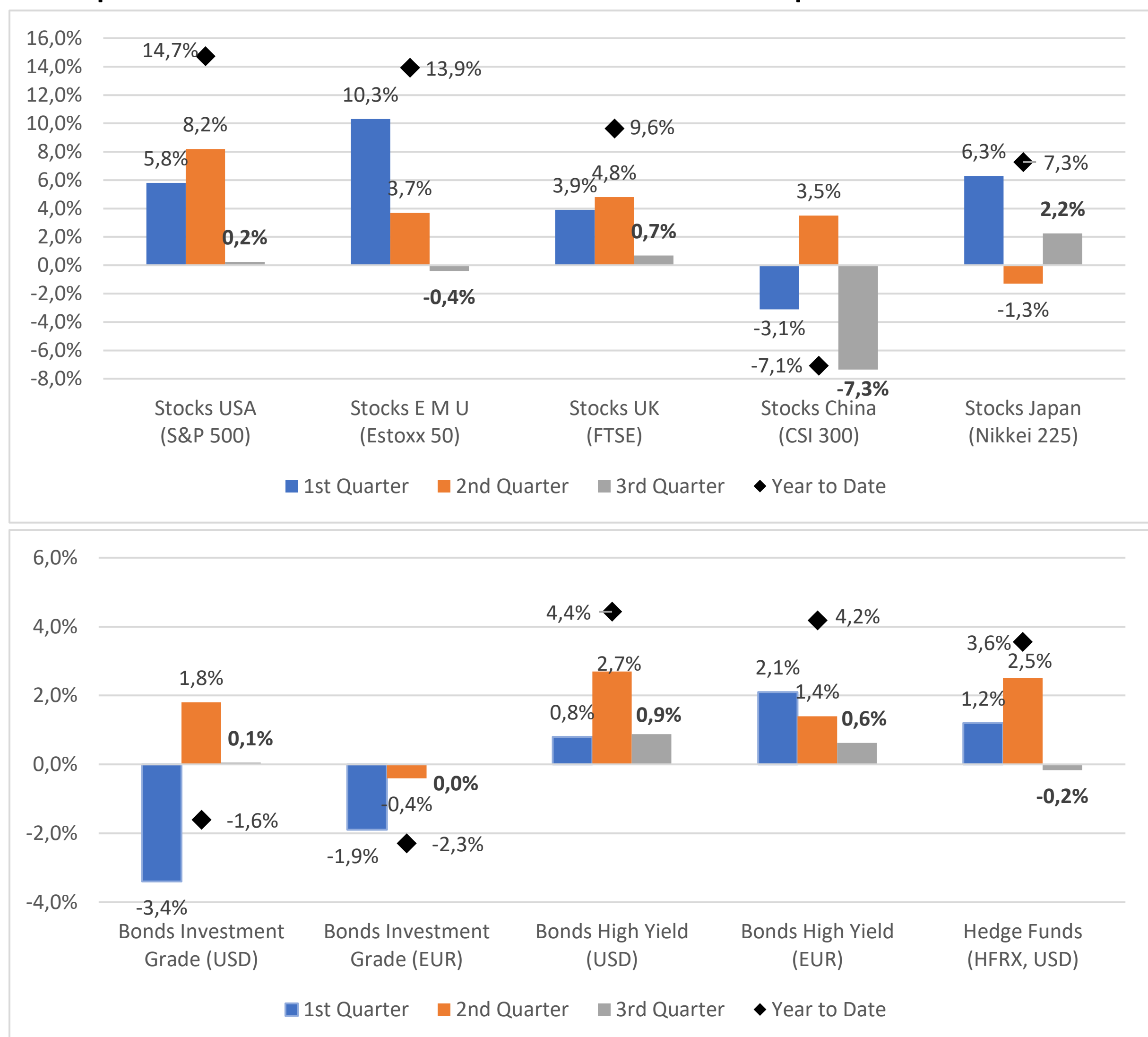
While until the beginning of September it still looked like a very pleasing performance across the board for the third quarter, the picture clouded over considerably, especially in the last two weeks before the end of the quarter. This was triggered by economic data that showed a clear slowdown in the economic recovery in many important economic sectors and regions and, at the same time, inflation developments that raised doubts about the central banks' ability to keep interest rates at the extremely low level for longer. These concerns triggered a significant rise in interest rates within a few days.

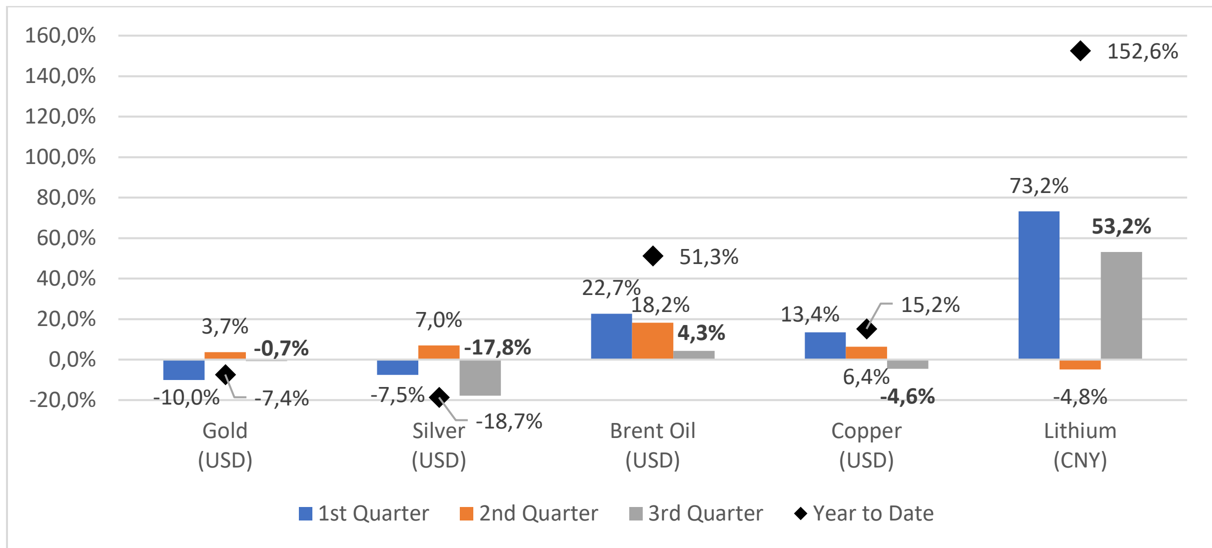
Many **stock indices** had still reached new all-time highs at the beginning of September, but were then thrown off course by the emerging fear of a change of direction in monetary policy towards a faster rate hike course. As a result, most stock markets ended the third quarter with a result close to zero, which at least preserves the thoroughly pleasing development of the first two quarters of the year. Exceptions are the Chinese and the Japanese stock market. In China, the development was determined by the clearly slowing pace of growth, but above all by the ideologically motivated harsh regulatory interventions in various sectors from art and education to media and online trade. The situation was further aggravated by the still looming demise of one of China's largest real estate companies (China Evergrande), which is considered by many to be China's "Lehman Brothers event" in terms of potential impact. Japan's stock markets, on the other hand, benefited from the emerging formation of a new government and the traditionally associated hopes for new economic stimulus measures.

Bonds were burdened by the renewed expectation of rising interest rates, which caused significant price losses, especially for government bonds. Corporate bonds were able to counter the rise in interest rates due to the continued good demand and the associated positive development of risk premiums and achieved a balanced (investment grade) or even clearly positive result (high-yield bonds) in the quarter.

In the third quarter, the **gold** price was not able to escape the impact of the recurring discussion about the so-called "tapering" (the expected withdrawal of the US Federal Reserve from its expansive monetary policy). Increased bond yields (even if still predominantly in negative territory in euro terms) and a potentially higher interest rate level lead to a strong loss of attractiveness of gold in the eyes of investors focused on short-term returns. Gold, as is well known, does not bring in any current income such as interest or dividends. This reaction is still understandable when looking exclusively at the short-term price potential, but it ignores the longer-term positive characteristics of gold in a well-diversified portfolio. For us, the price loss compensating qualities of gold in extreme market scenarios, which regularly trigger a flight of investors from risk assets, are of particular value. But the millennia-old function of gold as a universal store of purchasing power also seems important enough to us as a precautionary measure, especially in the current uncertainties surrounding the topic of inflation, to maintain the current weightings in our clients' portfolios.

Development of selected assets and commodities in the third quarter of 2021



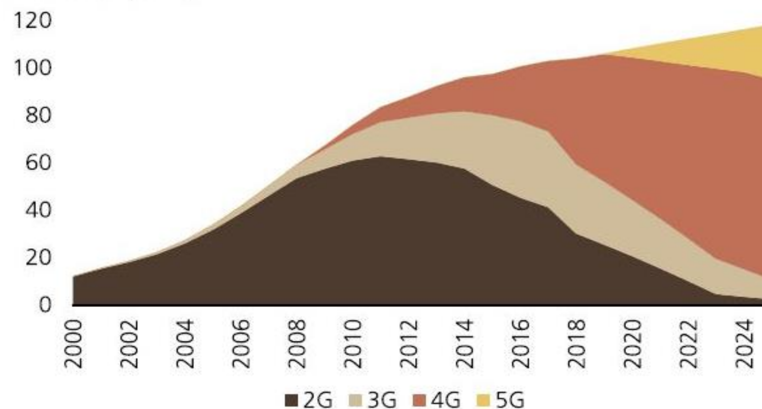


Source: Bloomberg

Theme investments - making use of future trends and special opportunities

We continued to expand the "Theme Investments" part of the portfolio in the third quarter. In July, we acquired an ETF (Exchange Traded Fund) for our core strategy portfolios, Defiance Next Generation Connectivity, which invests primarily in shares of companies that will benefit particularly from the rapidly expanding 5-G technology in mobile communications in the future.

The chart shows the length of use of mobile phone standards and the development of their market



With 5G technology, the speed of data transmission increases by a factor of 20 compared to 4G, with a 90% reduction in latency. This opens up new areas of application that are inconceivable with previous technology. These include, for example, autonomous driving, virtual reality, tele-surgery or the "Internet of Things" for industry.

Source: UBS AG

In our opinion, the 5G field already offers excellent investment opportunities today and will continue to develop over a period of several years in the most diverse forms of application. Currently, the focus is still on companies that manufacture semiconductors or equipment for the production of semiconductors and telecommunications networks. In addition, there are providers of telecommunication services and operators of cell towers. UBS estimates that annual investment in 5G will increase from US$7.5 billion (2019) to around US$150 billion in 2025. In the future, providers of 5G applications for end customers will also become increasingly important, which can support the future viability of this investment theme for many years to come.

Our investment in a basket of **cryptocurrencies** performed very well in the third quarter with the usual strong price fluctuations (+ 14.9% in EUR and + 17.3% in USD). Since the beginning of the year, the performance amounts to + 126 % (EUR) and + 114 % (USD).

Often unnoticed in the flood of news, which curiously often only takes place under the keyword "Bitcoin", is the enormous technological upheaval that has recently taken place. For example, the Ethereum network underwent one of the biggest updates to date in August, which massively reduces transaction costs and thus increases efficiency and attractiveness for new applications. Further adjustments, which also address the often-criticised climate-harmfulness of cryptocurrencies, are to follow shortly. The switch to the so-called proof-of-stake procedure will significantly reduce energy intensity. In our impression, the various digital currencies are increasingly differentiating themselves from each other, so that an exclusive perception of "Bitcoin" would fall short for a long-term planned investment.

We feel strengthened in our assessment that cryptocurrencies and their underlying technology represent a very promising investment for the future, which is now also being discovered by more and more institutional investors. Even government campaigns against digital currencies, such as the recent ban on all activities related to Bitcoin for Chinese, will not be able to prevent the further development of cryptocurrencies into a new asset class "digital assets" in the long run.

What is likely to be keeping us busy in the coming months

Inflation is not the only topic that requires a lot of attention. Here is a small selection of other developments that are currently relevant for our investment strategies:

- The constitutional debt limit for the US national budget was reached once again shortly before the end of the third quarter. The traditionally ensuing political duel between Republicans and Democrats, which should result in a renewed raising of the debt limit, is being fought particularly bitterly, since the Congressional elections are coming up next year. The now extremely hardened fronts only allowed for an emergency solution valid for two months to avoid the otherwise threatening insolvency in mid-October. For purely political motives, the parties are putting the creditworthiness of the United States at risk. A default would most likely result in considerable chaos on the financial markets. A look back at the market reactions in 2011, where an agreement was only reached at the last minute, gives us an idea of the possible consequences.

- If the US Federal Reserve decides to start reducing its extremely bloated balance sheet soon, a lot will depend on how it communicates its steps. In principle, stock markets can also develop positively with rising interest rates. The speed at which interest rates rise and the reasons for the rise are ultimately more important than the absolute level of the interest rate. The biggest "communication accident" so far is still the FED's attempt in 2013, which is still remembered as the "Taper Tantrum".
- The economic recovery from the severe slumps during the Corona pandemic is now noticeably weakening worldwide. The reasons for declining growth rates are multiple. The return to a normal level of activity plays a role. Due to the fact that demand is no longer increasing strongly (expiry of catch-up effects), growth rates are now much more difficult to achieve. Increasingly widespread disruptions in supply relationships, whether due to material shortages, lack of intermediate products or transport capacities, are an additional burden. Under these circumstances, it will be difficult to generate further growth momentum. Rising costs (wages, energy, raw materials), which cannot always be passed on immediately and indefinitely to customers through higher prices, reduce companies' profit margins.

What you can expect from us

It seems that we are on course for a change of era on the financial markets. The phase of high growth rates and low inflation seems to be definitely over. Upheavals always require a great deal of attention and flexibility. They are full of opportunities, but also bring new and previously unknown risks.

At BPM, we are happy to use our exceptional freedom of thought and action to tap into the opportunities that present themselves for your portfolio in the future while keeping all conceivable risks under control in the best possible way.

BPM – Berlin Portfolio Management GmbH

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