Lotos Asset Management AG

Quarterly Investment Strategy

Lotos
Asset Management

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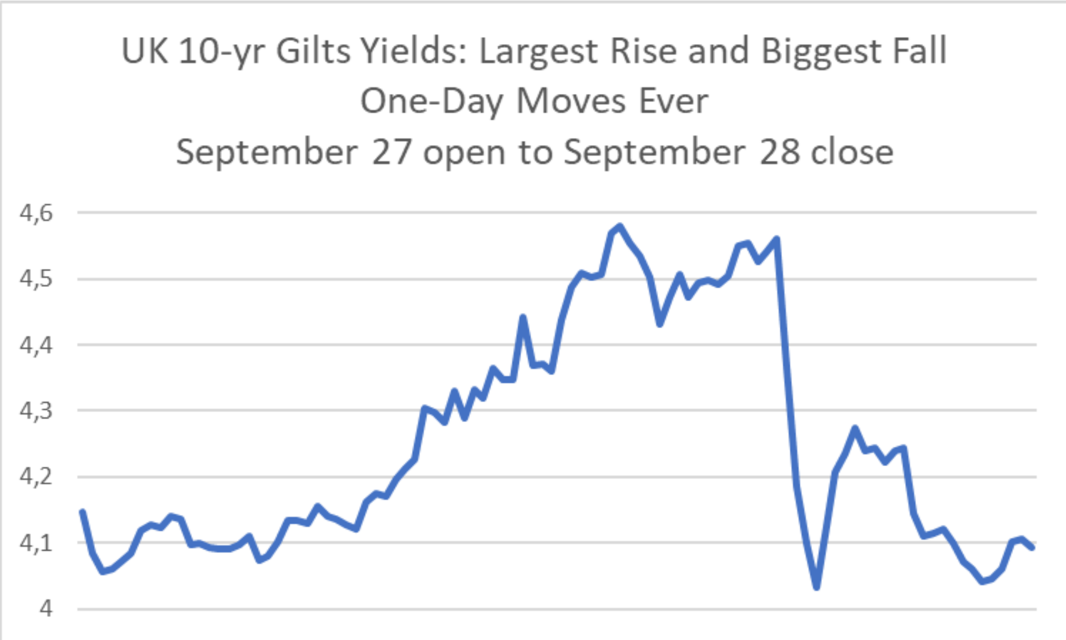
Inflation versus Financial Stability

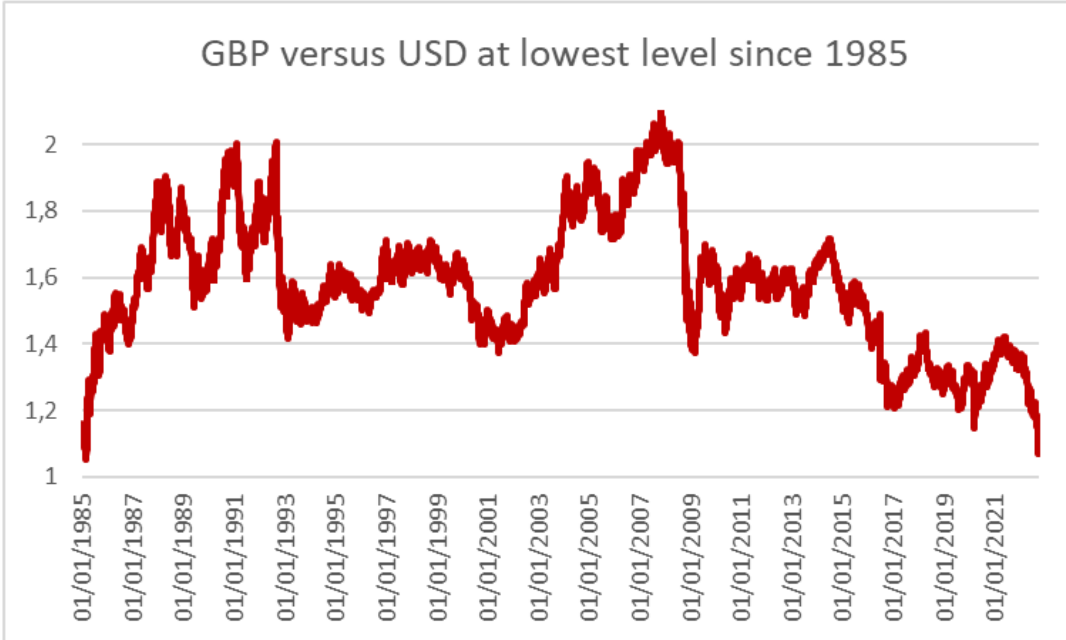
Investors desperately try to figure out when and what could trigger a change in the current Federal Reserve (Fed) Policy of aggressively fighting inflation.

End of September, the Bank of England (BoE) involuntarily answered the question: Endangered Financial Stability. We all know about the turbulence and volatility that occurred. But what exactly happened? And why could that have a relevance for Fed policy?

The new UK government under Liz Truss initiated the biggest package of unfunded tax cuts in half a century in the face of widespread opposition from economists and investors. A sudden, enormous move in government bond yields ensued. Yields rose so sharply that pension funds and investment managers had to meet margin calls within hours. Usually, these parties hold enough cash or liquid assets to cover margin calls. Also, they normally have several days or even weeks to make the payments. Since time, however, became a critical factor, institutional investors started to sell their most liquid asset: Gilts. With the enormous amounts of gilts being sold all at the same time, yields jumped. This triggered yet another round of margin calls. The perfect vicious cycle had been created. Only one party was large enough to break it – the BoE. This intervention triggered the largest fall on record for UK long-term yields, only a day after their biggest ever spike. In figures, this means the yield of the 10-year Gilt went from a low of 4.06% on September 27 to a high of 4.58% on September 28 to end the day slightly above 4%. Importantly, gilts are benchmark rates and therefore impact borrowing costs in the wider economy, notably for real estate and corporate borrowing markets. The BoE was really forced to act to prevent a dysfunction of the system. Ironically, the fight of inflation by increasing interest rates and bond sales had abruptly to give way to unlimited bond buying.



Source: Bloomberg



Source: Bloomberg

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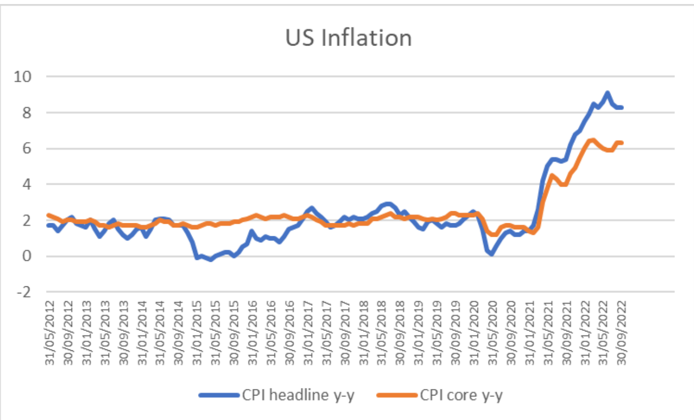
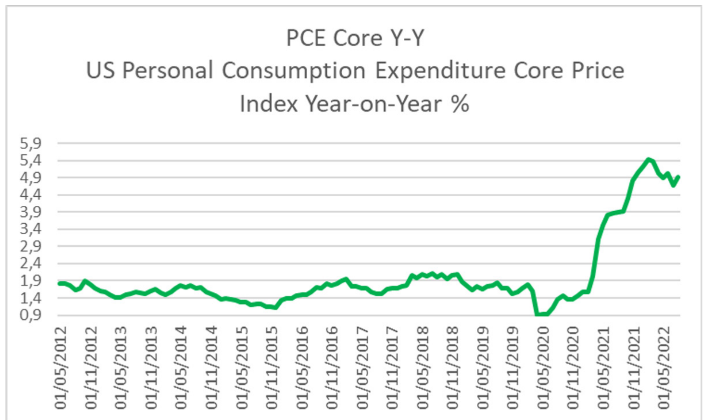
Interestingly, just one day before the UK trouble started, the Federal Reserve of New York published a paper on Financial (In)Stability. It explains the issues the Fed is currently facing and proposes a complementary concept that is called the "financial stability real interest rate, r**. The reason for this new theory lies in the inflation pressure that we are currently facing and argues with the excess leverage built up in the economy, the financial system cannot sustain rates high enough to reach a level of rate for the real economy, in which supply equals demand and there is no inflation. There is in fact a widening gap between the Fed Fund Rates and the core CPI. That means that the **financial system becomes unstable before the Fed is able to raise rates high enough to impact the labor market.** Stated differently, the Fed would reach a point where it had to address financial instability before it can contain the inflation pressure. Should this theory hold, the Fed would experience a similar fate to the BoE: The Fed would have to tackle financial instability at the same time as it tries to rein in inflation. The time of interventions would then unfortunately not be over.

Market participants, meanwhile, are focused on incoming data analysis. The elevated volatility reflects mixed reports. On the one hand, there are signs that inflation is topping out, particularly in US leading indicators, such as from the Supply Management (see below charts). Yet some recent figures did not meet expectations, which also explains the market corrections mid-August to end of September. And on the other hand, economic data is inconclusive, particularly on the labor side. Let's review some inflation and economic statistics:

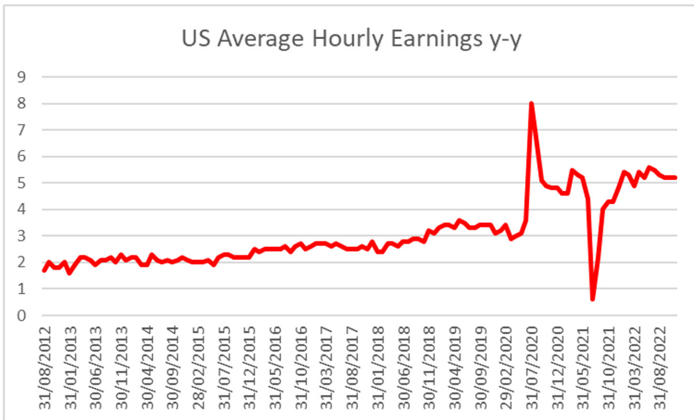
Key Inflation gauges:



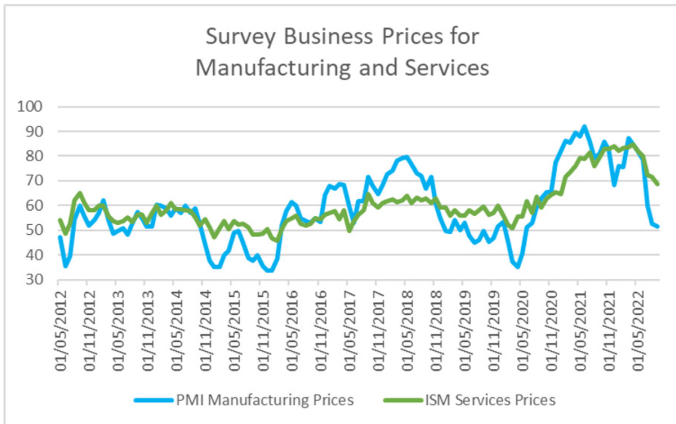
Source: Bureau of Labor Statistics



Source: Bureau of Economc Analysis



Source: Bureau of Labor Statistics

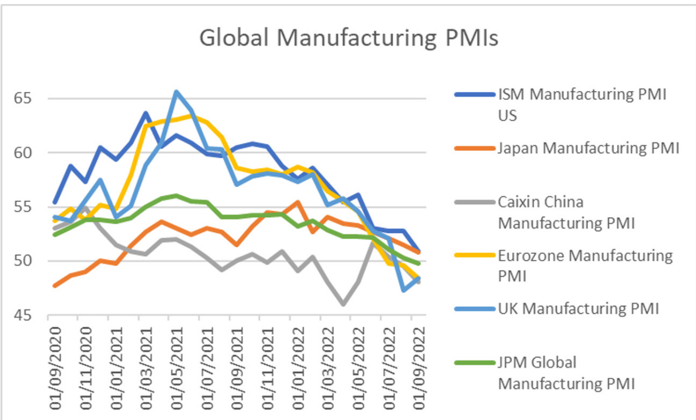


Source: Institue of Supply Management

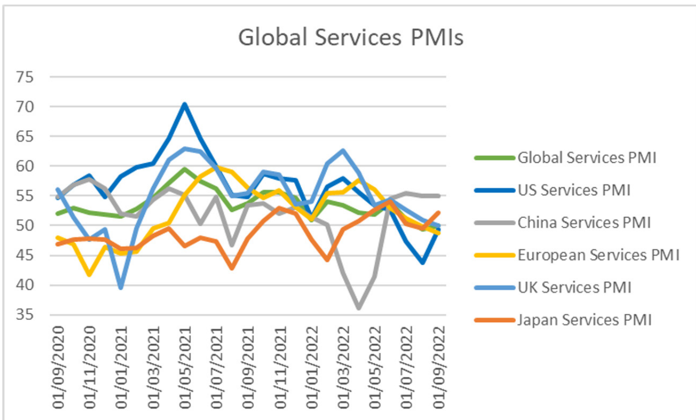
Inflation versus Financial Stability

On the economic front, global manufacturing has weakened since mid-2021. The PMIs are currently around levels in all major economic zones that indicate neither growth nor recession with China, Europe and the UK the weakest (picture to the left; neutral level 50). An important sub-component for future growth is the report on new orders. In the US, it surprisingly dropped to 47.10 and new export orders to 47,8, both hinting to a contraction. Lower demand but also a reduction in inventories seem the main triggers. The Services global PMI currently sits exactly on the neutral line of 50 (see second chart to the left). China shows the best dynamic, but this is a relatively new economic indicator there and hence not very reliable. One quite reliable leading indicator – Philadelphia Fed index (see picture second to the right) –was in negative territory but rebounded somewhat. It also showed a drastic fall in new orders (yet an evenly dramatic fall in prices paid).

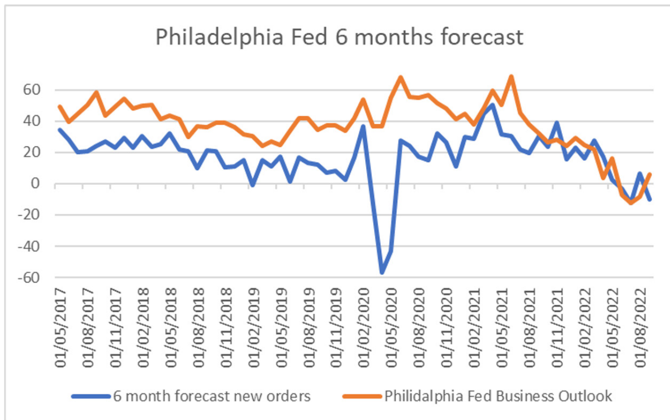
In any case, the US might already be in a recession. There were many discussions previously because there was a particularly large gap between the GDP (gross domestic product) and GDI (gross domestic income) with the latter still showing growth whereas the GDP pointing to an abrupt slowdown. With the revision, both indicators are now in negative territory for two subsequent quarters, which qualifies for at least a technical recession. The official arbiter, the National Bureau of Economic Research's Business Cycle Dating Committee, uses the average and a range of other economic variables to make any recession call. One reason that might have held them back is the unusually strong labor market. Data from the employment side are currently so important because labor-related inflation tends to be very sticky. Investors would therefore be much more comfortable if the were signs of a more balanced employment situation. The interpretation in this space is particularly tricky, because it is difficult to know if any reported weakness in the labor data is due to a weakening economy or because it is difficult to find the suitable workforce. The market reacted very positively on an indicator called "US Job Openings" (see chart to the right), which dropped to a 14-month low thereby finally confirming some labor weakness.



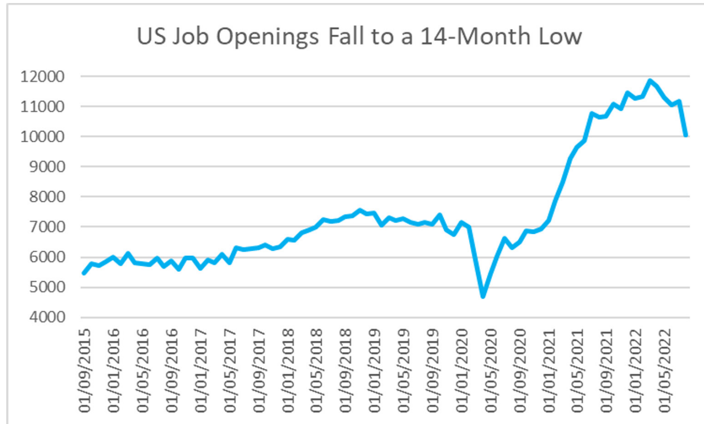
Source: S&P Global



Source: S&P Global



Source: Philadelphia Federal Reserve



Source: Bureau of Labor Statistics

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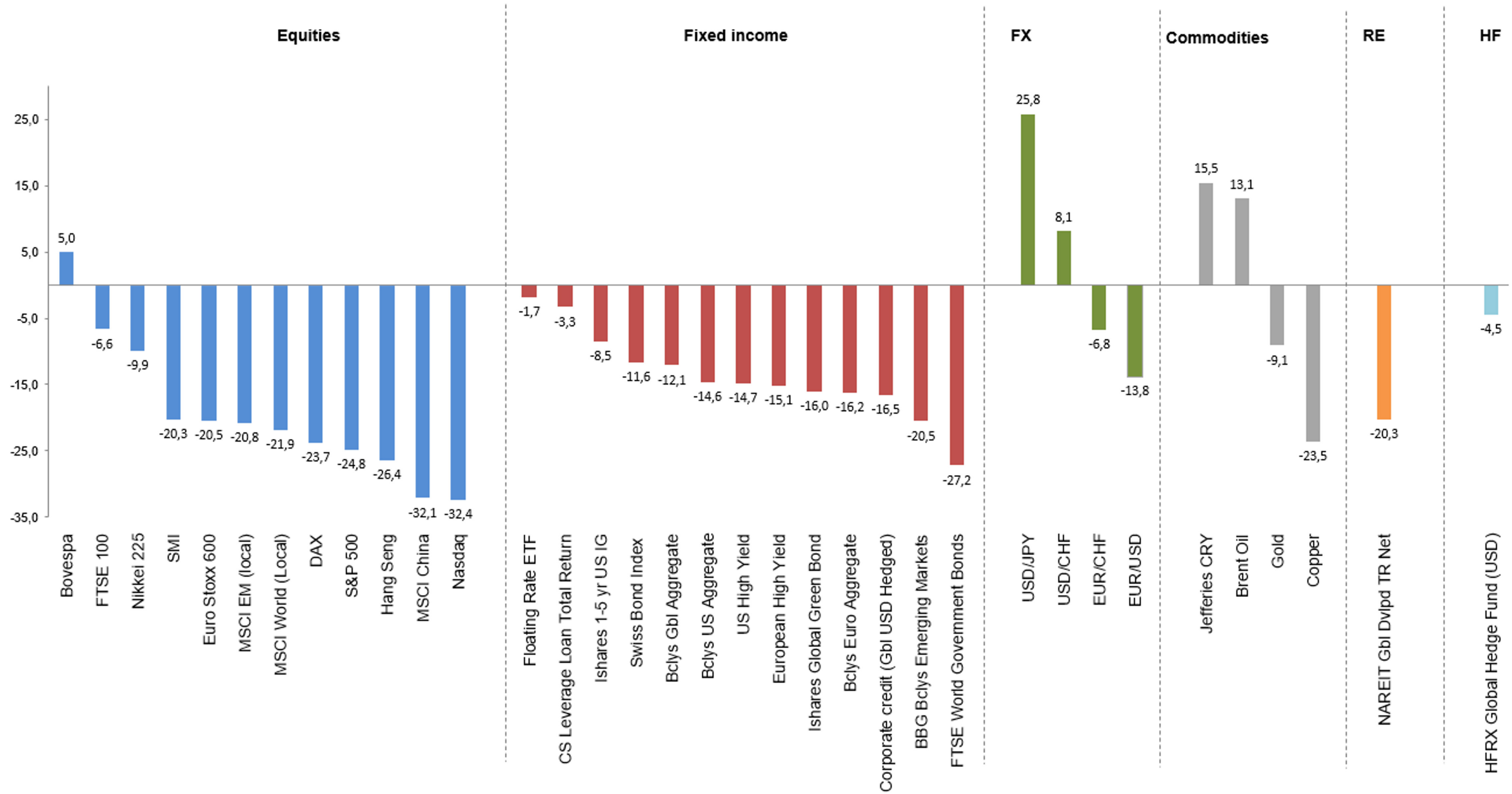
Conclusion

- Central banks have waited far too long with their exit strategies.
- They must now solve the inflation fire by force and risk destabilizing the financial system.
- We remain the most favorable vis-à-vis the US market as the Fed aggressively addresses inflation and the economy has the best potential to recover first. The Fed Beige Book, which gathers information from a variety of business and nonbusiness sources, offers indications that supply chain bottlenecks, staff shortages and general cost pressures are diminishing somewhat.
- Until there is a clear trend in declining inflation pressure, markets will remain volatile.
- 2Q company reports, in many instances, supported the view of less strain in supply chains. We are just before the 3Q earnings season and are eager to know what the thinking now is.
- Global stocks have already taken into account a substantial drop in earnings forecast due to inflation and macroeconomic developments (see below picture to the left). Should some of the strain in respect to supply chain and labor should be mentioned by managements, it could have a positive impact.
- We remain slightly overweight equities, notably in the US.
- We remain underweight fixed income. The portfolios mostly hold investment grade bonds with relatively short duration.

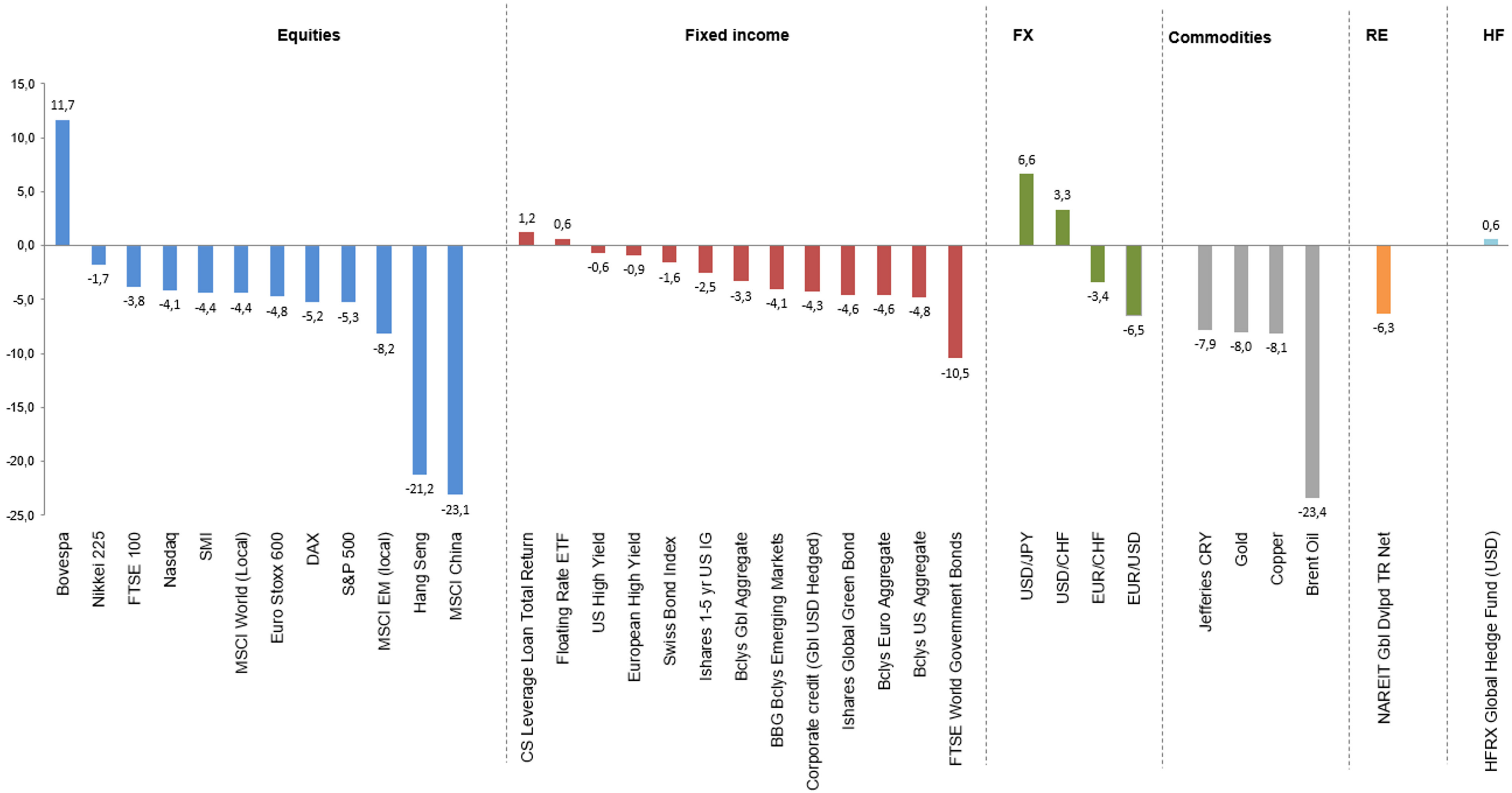
Source: Bloomberg

Source: Bloomberg

Performance Major Asset Classes YTD 2022 in Local Currencies



Performance Major Asset Classes in 3Q 2022 in Local Currencies



Performance Major Asset Classes in 3Q 2022

- In **Equities**: While China was the only region to generate a positive return in 2Q, the picture totally reversed in 3Q: it plunged over 20%. Renewed Covid quarantines and the ongoing stress in the real estate market explains this weakness. Even specific home loan rate limit relaxation could not lift investors' mood. In addition, China's export growth was impacted more than expected by the slowing world economy. Emerging Markets in general also suffered from USD strength, the Ibovespa being the exception. Brazil has certain advantages in terms of fundamentals and the level of interest rates. Other major markets all ended the quarter in the red. While the performance in Japan looks comparatively attractive, this only holds when the Yen had been hedged. The FTSE 100 held up relatively well on valuation grounds. The Nasdaq finally stabilized somewhat as higher interest rates seem now more reflected in equity prices. The fact that the Nasdaq was even slightly outperforming the S&P500 could be indicative that stock investors start to believe the Fed can indeed reign in inflation pressures.

- In **Fixed Income** Short-Duration bonds continued to outperform and World Government bonds led again the laggards. Interestingly, High-Yield bonds both in the US and Europe slightly corrected but outperformed many other fixed income sub-classes. They benefited from the rally in risk assets from the start of July until mid-August but subsequently fell again.

- **Commodities** suffered on recession fears. Brent corrected over 20% but remained in positive territory for the year. Gold and Copper were in line with the performance of the core commodity index.

- **Global Real Estate** continued to correct as a reaction to higher mortgage rates and recession fears. Hedge Funds showed a razor thin positive performance in

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