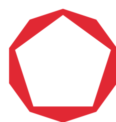
Capital Market Report 2021



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Capital Market Report 2021

Dear Clients,

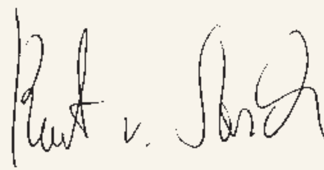
The year 2021 will go down in the history books as another year of the Coronavirus. The virus continues to generate new variants and dominate our everyday lives. Hopes are growing, however, that the pandemic will soon become endemic and in the not too distant future we will be able to live with the virus with no need for restrictions.

The equity markets, at least in the industrialised countries, are reflecting those hopes and rose again in 2021, in some cases significantly. In the meantime, dear clients, you have entrusted us with more than EUR 80 billion of your assets.

Your trust acts as both an incentive and an obligation for us. As a result, in addition to fulfilling our value proposition to earn adequate long-term returns for you, we are also developing new organisational structures to keep pace with the growth of our company.

In 2021, for example, we were able to attract highly talented and experienced employees. More than 300 employees at various locations in Europe are now taking care of your assets. We also implemented a partnership model where senior executives share in the company's performance with the aim of increasing long-term loyalty. And, to name another example, we created Flossbach von Storch ONE to provide digital access to our private asset management.

Best wishes to you and your family for a good, and above all healthy, start to the New Year. Thank you for your confidence in us!



Dr Bert Flossbach Kurt von Storch Dirk von Velsen

REVIEW

Alpha, Beta, Gamma, Delta, Omicron. The SARS-CoV-2 virus continues to generate new variants. In spite of greater transmissibility and large numbers of infections, the latest variants have not led to restrictions like those introduced in the spring of 2020, when factories were closed and the streets were empty. We now have vaccines and justified hopes that the pandemic will eventually become endemic. People and the economy have come to terms with the virus to some extent, partly because it is now clear that SARS-CoV-2 is going to remain with us.

The "zero-Covid" strategy implemented by some countries has proven unsustainable since it requires complete isolation of the country, which is not socially or economically justifiable in the long term. China's isolation policy was initially quite successful in combating the pandemic, but was also welcomed as an opportunity to expand the surveillance state and was accompanied by extreme restrictions on people's mobility. With a population of 1.4 billion, China also has an enormous internal market and therefore benefits greatly from a revival of domestic consumption. In addition, the volume of international trade in goods is greater than for cross-border services, which means that isolation is economically manageable as long as the flow of goods continues relatively unhindered. This is still largely the case, in spite of the congestion at some ports.

Following the sharp downturn last year, the global economy is expected to grow six per cent in 2021. The economic output of the two superpowers, the USA and China, is already above the pre-crisis level. The other major economies, however, are still lagging behind. Real gross domestic product (GDP) in the eurozone is still around two per cent below the level in 2019, and close to four per cent in the United Kingdom (see Figure 1 on the following page).

This further increases the weight of the two largest economies, the USA and China. The USA contributes around 24 per cent of global economic output, followed by 18 per cent for China, which is continuing to catch up. Germany contributes 4.5 per cent, which is only a quarter of the share from China.

Financial market participants have also come to terms with the Coronavirus and are looking to the future. Reports of rising numbers of infections or new variants no longer lead to large stock-market setbacks, but instead only affect sectors or companies that are particularly heavily impacted. The previous year also showed the effects the pandemic had on individual sectors of the economy, demand structure, technological change and inflation. The Coronavirus caused demand to shift from services to goods. Money that was no longer spent on travel or events was mainly used to purchase consumer

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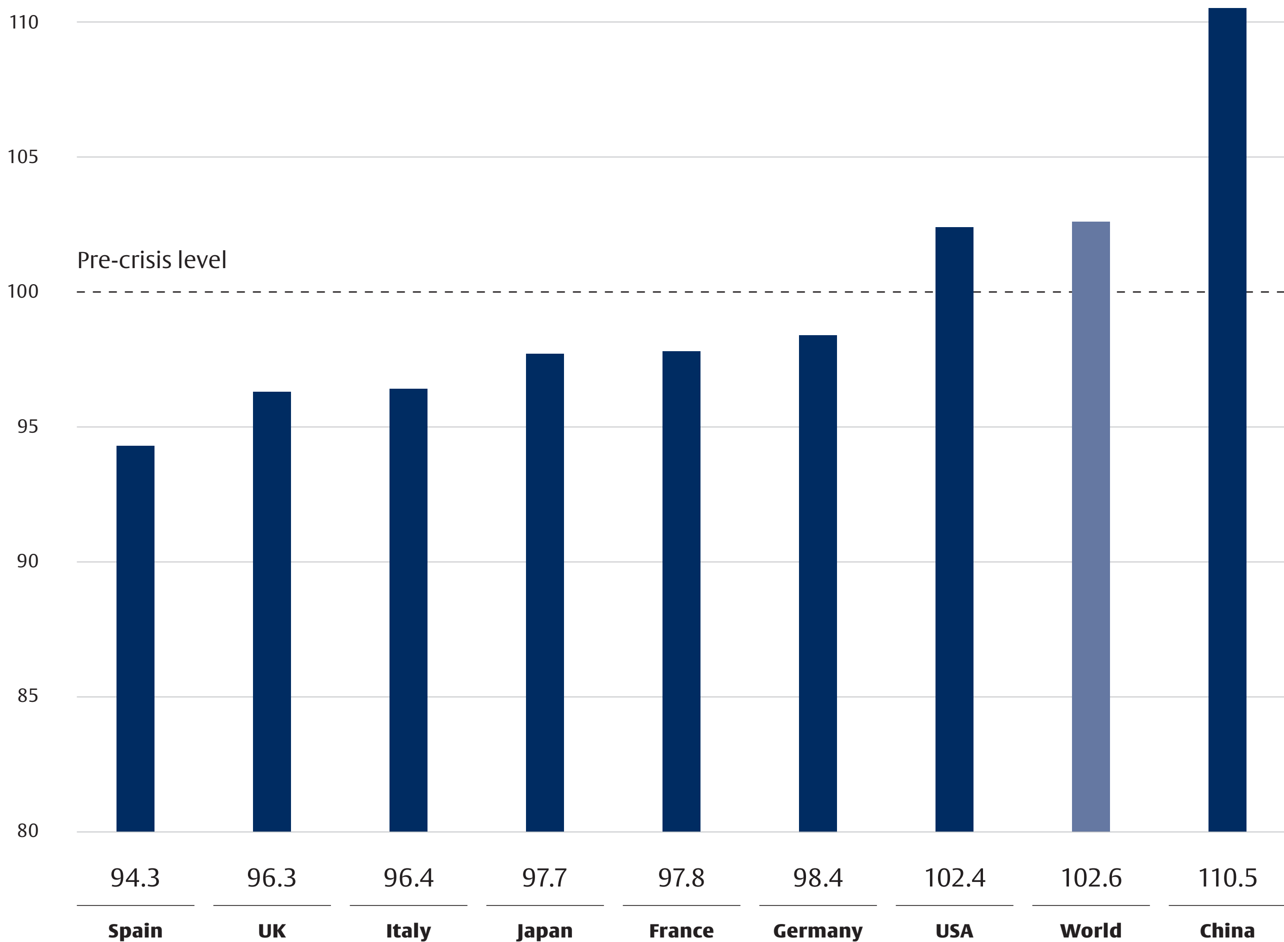
Figure 1

Europe is lagging behind

Economic output at the end of 2021



Estimated 2021 gross domestic product* (in constant prices, indexed to 2019 = 100)

* Estimates from the October update of the IMF World Economic Outlook.

Source: Refinitiv, Flossbach von Storch, data as at 6 January 2022

durables, such as electronics, cars and housing needs. Production capacity was unable to keep up in some cases, leading to shortages of some intermediate products that were made even worse by logistics bottlenecks. The resulting increase in inflation is unusual both for its magnitude and the nature of the increase. The high inflation rates are mainly due to supply problems on the production side that can only be eliminated in some cases by building additional production lines and factories. Semiconductors are an example of this. Since these changes cannot be made overnight, the high level of inflation the central banks were telling us was temporary just a few months ago will likely continue a while longer.

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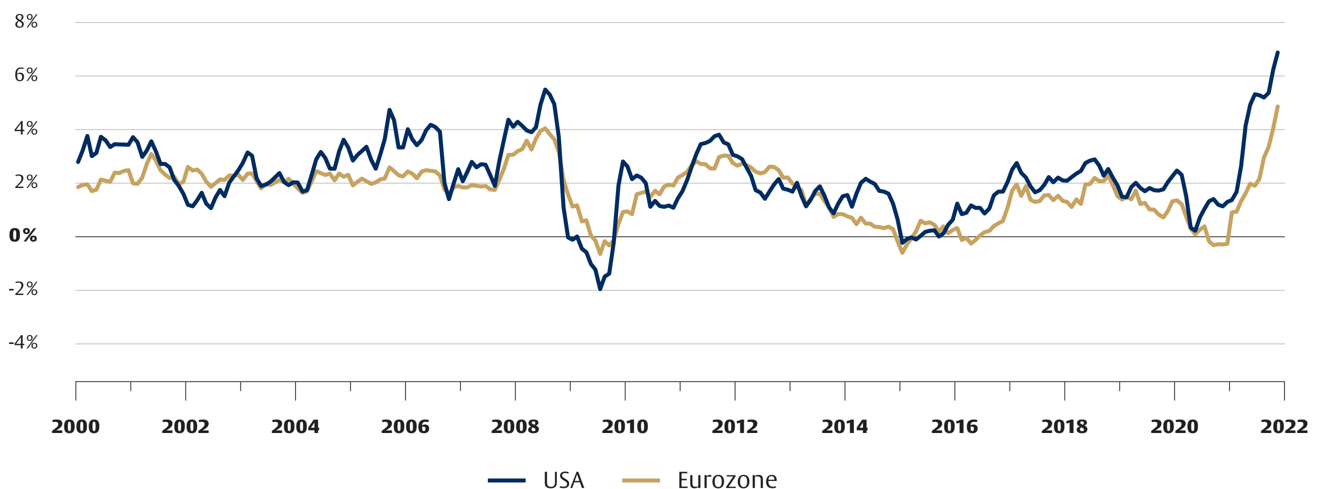
Bonds

The US Federal Reserve (Fed) was the first to react to rising inflation and announced in December, in spite of the appearance of the Omicron variant, that it would be ending its (net) bond purchases in March, which suggests that several key interest-rate increases should be expected in 2022. The slight tightening of Fed policy has not yet had any major effect on 10-year US Treasury yields. Yields only rose moderately during the year, from 0.9 per cent to 1.5 per cent at year-end, and are therefore even below the level in March and April – in spite of the fact that inflation was 6.8 per cent in November, the highest level since 1982 (see Figure 2). For holders of US Treasuries, the small increase in yields nevertheless represents a loss of around four per cent over the year (incl. interest income) – and this is before accounting for inflation.

At minus five per cent (10-year US Treasury yield of 1.5 per cent minus the rate of inflation), real yields have reached their lowest level in the USA since the early 1950s. Capital market investors, however, are expecting inflation to decrease significantly again. This is shown by the yield on 10-year TIPS (Treasury Inflation-Protected Securities), which was around minus 1.0 per cent at the turn of the year, or 2.5 per cent below the yield on a non-inflation-linked bond. The difference reflects current inflation expectations for the next decade and, although it is higher than the recent past, this is barely higher than the average of two per cent over the last 10 years (see Figure 3 on the following page).

Figure 2
Rapid increase in consumer prices after years of low inflation
Year-on-year change in monthly inflation



Source: Refinitiv, Flossbach von Storch, data as at 6 January 2022

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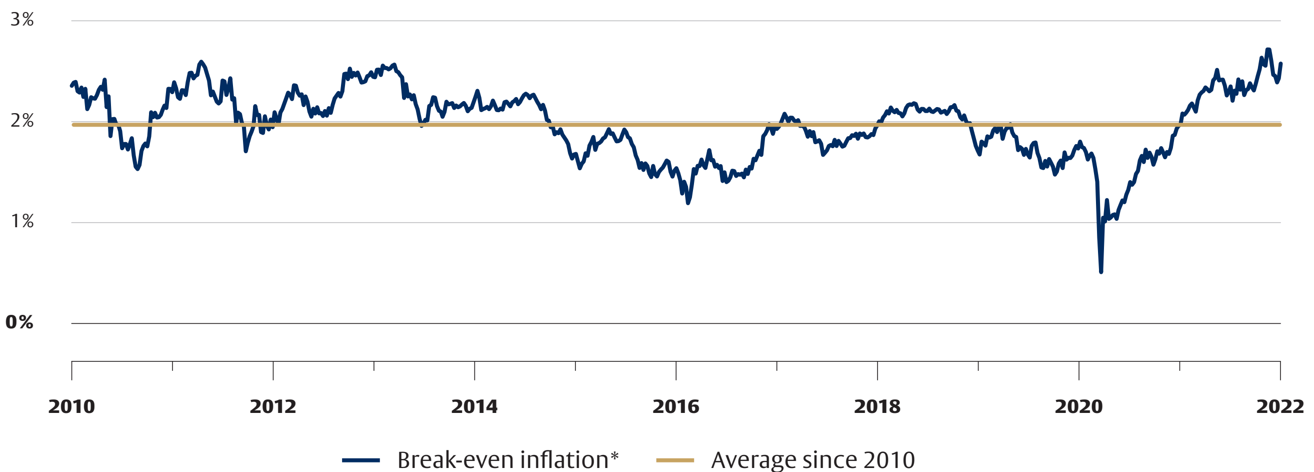
Figure 3

US inflation expectations

Break-even inflation* for 10-year US Treasuries



* Annual inflation adjustment that would have to be paid in order to generate the same return on 10-year US Treasuries and 10-year TIPS (Treasury Inflation-Protected Securities) at maturity.

Source: Refinitiv, Flossbach von Storch, data as at 6 January 2022

Past performance is not a reliable indicator of future performance.

Unlike the Fed, the European Central Bank (ECB) is playing for time. On 16 December, it announced it would end its pandemic emergency purchase programme (PEPP) in March as planned. It could, however, be reactivated if new waves of Coronavirus occur or economic data is poor, according to ECB President Christine Lagarde. She also indicated that the economy continues to need monetary policy support. The regular asset purchase programme (APP) will therefore continue in 2022 with purchases of EUR 330 billion in bonds. Given the record high inflation rate of 4.9 per cent (November), continuing its easy monetary policy puts the ECB at risk of losing credibility as the protector of price stability. To counter this, Lagarde stated that inflation was a bit more persistent than initially thought, and raised the inflation projection from 1.6 to 3.2 per cent in 2022. In the medium term, however, inflation is expected to decline considerably to just 1.8 per cent in 2023 and 2024, which would be below the target level of two per cent. In our view, however, this all-clear message is more of a justification for continuing its ultra-loose monetary policy than a realistic assessment. The motto “nice weather tomorrow” has now become “the day after tomorrow” (see the Capital Market Report for the third quarter).

The yields on safe eurozone government bonds appeared largely unaffected by the sharp rise in inflation. The yield of minus 0.18 per cent for 10-year German government bonds (Bunds) at the end of the year was just 0.4 percentage points higher than the previous year, when inflation was still less than zero and the environment was generally deflationary. Due to the low level of yields, even small price reductions were enough to decrease the value of German Bunds by 1.7 per cent (based on the REXP bond index). For eurozone government and corporate bonds, the loss was even 2.9 per cent (Bloomberg Euro-Aggregate Index).

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Equities

The situation was different for equities, which benefited from both the economic recovery and the ongoing low interest-rate environment. This was particularly true for shares in growth companies, whose earnings potential lies further in the future than companies with slower growth. The lower the interest rate used to discount these earnings, the higher their present value today. This is a major reason for the above-average performance of 28.2 per cent recorded by the US S&P 500 equity index (see Figure 4 on page 9), which contains a particularly large share of high-growth technology stocks with high weightings in the index. The seven stocks with the largest market capitalisations – Apple, Microsoft, Alphabet (Google), Amazon, Tesla, Meta Platforms (Facebook) and Nvidia – represented more than 25 per cent of the index and generated around 36 per cent of the index earnings last year. In January 2022 Apple's market capitalisation even reached the magical mark of USD three trillion for the first time, which is 1.5 times the market capitalisation of all 40 stocks in the DAX index.

Not all boats, however, were lifted by the rising tide in the stock market last year. Even some of the stars in the supposedly homogeneous technology sector lost considerable ground after rising to levels that were scarcely justifiable based on fundamentals during the earlier Coronavirus boom.

There were also large international differences Emerging market equity markets, which were generally praised as a source of growth, turned out

Not all boats were lifted by the rising tide in the stock market last year. Even some of the stars in the supposedly homogeneous technology sector lost considerable ground after the earlier Coronavirus boom.

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to be disappointing, ending the year down 2.5 per cent based on the MSCI Emerging Markets Index (up 4.9 per cent in euros). Performance was especially poor on the Hong Kong stock market, where the shares of major Chinese companies are traded. Imploding real-estate stocks and, in particular, sharp share-price losses for the large Chinese Internet companies, which are increasingly being reined in by the government, weakened the confidence of international investors, leading to a loss of 14.1 per cent.

European equities performed well in contrast, recording a gain of almost 26 per cent (based on the Stoxx Europe 600). A few stocks with high capitalisations, such as Nestlé, Roche, ASML, LVMH and Novo Nordisk, were also responsible for driving this index higher due to their large weightings and strong performance (average of 50 per cent in euros), although not with the same dominance as the heavyweights in the S&P 500. The 15.8 per cent increase recorded by the DAX index was somewhat more modest when compared internationally, as shown by the MSCI World equity index, which rose a good 22 per cent in US dollars and 31 per cent in euros.

The MSCI World index has become the ultimate benchmark for global investors in recent years. It is like a "Holy Grail" that promises to deliver investors from the drudgery of extensive analyses and individual stock selection.

Due to its broad diversification, with 1,555 companies in 23 industrialised countries and 14 currency areas, it holds out the promise of benefiting from the performance of almost all the major companies in the world. The reality, however, is different now. The MSCI World index has mutated into a US equity index with a bit of an international touch. Almost 70 per cent of the index consists of US stocks, including around 18 percentage points due to just seven companies, the "Big Seven" that were mentioned before. As a result, their share of the index is almost as large as the weight of the five largest countries after the USA (around 6.5 per cent for Japan, almost four per cent for the United Kingdom, a good three per cent each for Canada and France and somewhat less than three per cent for Germany). Almost half of the index performance last year was due to gains by the "Big Seven" and the increase in the US dollar.

The strong performance by the big technology stocks and US dollar has been highly beneficial to the performance of the MSCI World index in the past 10 years when calculated in euros. The rapid growth in passive investment strategies, such as the use of ETFs to invest in major indices, also contributed to this. As apologists for a global investment strategy, we are also naturally in favour of a global benchmark for structuring portfolios and measuring their performance. However, when index performance is increasingly dominated by just a few stocks and the ups and downs of the US dollar, investors, particularly those in the eurozone, have to ask whether the MSCI World index is really reflecting the global equity universe in a meaningful way. For example, our two global equity funds each recorded a performance of 28 per cent in the year just ended. Although this was three percentage points below the MSCI World index, they are less volatile during market crashes, like the one in 2020. That the funds still managed to end up in the top 20 per cent of their comparison universe in 2021 is also due to the fact that global equity funds generally do not invest as heavily in the US dollar area as the index does. This can also be an advantage, as shown by the five-year period from the end of 2002 to the end of 2007, when the Euro STOXX 50 recorded a performance of 108 per cent and the DAX 179 per cent, while the MSCI World index only achieved a gain of 57 per cent, making it anything but the measure of all things.

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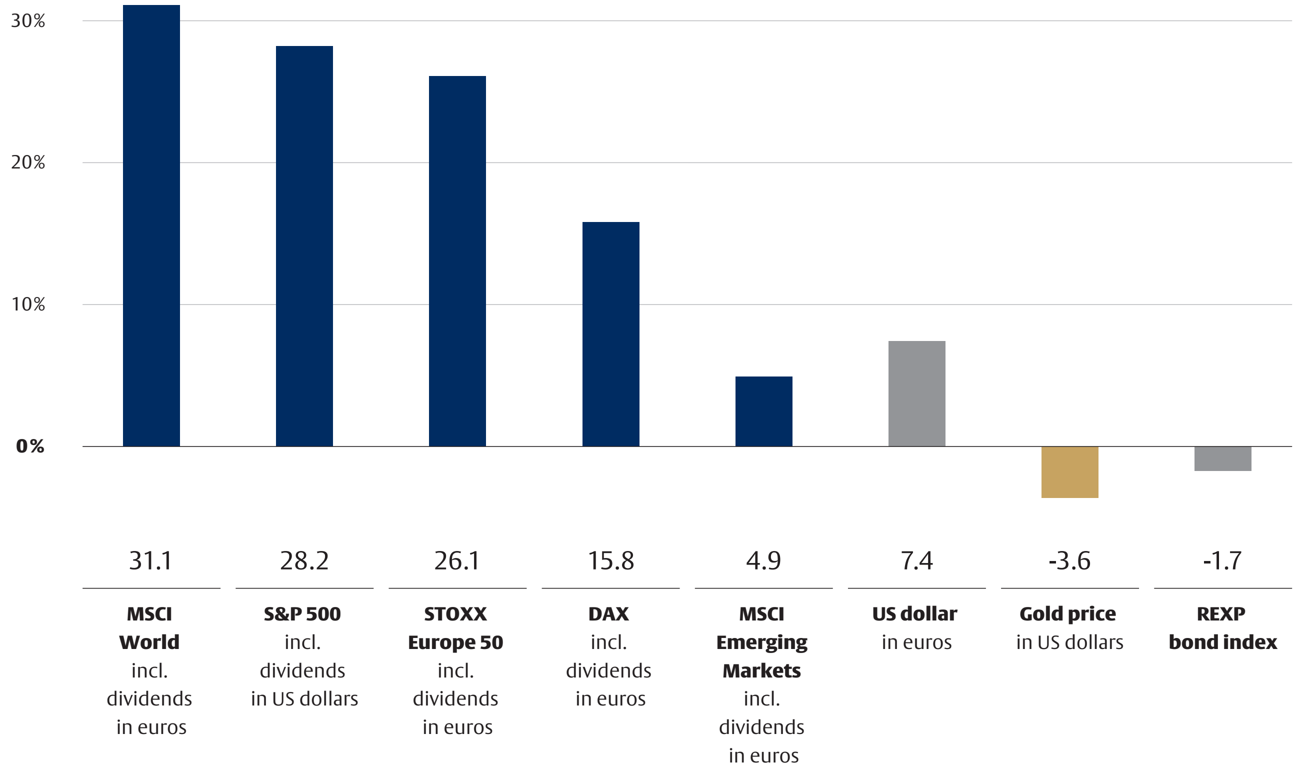
Figure 4
Capital market performance 1 January to 31 December 2021



Source: Bloomberg, Flossbach von Storch, data as at 31 December 2021
Past performance is not a reliable indicator of future performance.

Although the MSCI World index has become a kind of "Holy Grail" in previous years, it is not a world index, but instead a US index with an international touch.

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Gold

The gold price performance was rather disappointing given an ideal breeding ground of rising inflation and negative real interest rates. The year-end level of USD 1,829 represents a loss of almost four per cent compared to the previous year. Thanks to the rise in the US dollar, a gain of almost four per cent nevertheless remains when the return is calculated in euros. As shown by the outflows from gold ETFs, whose volume fell almost 300 tonnes to 3,043 tonnes, investors took profits after the large price increase of 25 per cent (in US dollars) in the previous year. Concerns about an interest-rate turnaround raising the opportunity cost of gold, which bears no interest, likely also put pressure on its price.

In addition, competition from cryptocurrencies, in particular bitcoin, which many investors now feel provides alternative digital protection against inflation, is also increasing. As a result, several billion US dollars that would normally be invested in gold likely flowed into digital safe havens. At a year-end closing price of USD 46,334, the 19 million bitcoins that have so far been created have a value of close to USD 900 billion. Ether, the second-largest cryptocurrency, whose production is also highly energy-intensive, but not limited, is worth around half as much. In comparison, the value of the approximately 200,000 tonnes of gold that has been produced over time has a value of almost USD 12 trillion. 35,000 tonnes of this is held by central banks and slightly more than 3,000 tonnes is in the vaults of gold ETFs. It is estimated that private households in Germany hold 9,100 tonnes, almost three times as much investment gold (gold coins and bars) as the Bundesbank, and therefore likely have the largest holdings worldwide. Since gold jewellery could also be melted down, it is difficult to determine the total amount of investment gold.

The importance of gold as a safe haven could recently be seen in Turkey. The country has experienced repeated waves of inflation and currency depreciation. The official inflation rate was 36 per cent in December. The Turkish lira depreciated 44 per cent versus the US dollar last year and 74 per cent over the last five years. It is therefore completely understandable that Turkish savers are not being misled by high interest rates and instead prefer gold as a long-term store of value.

Given an ideal breeding ground of rising inflation and negative real interest rates, the gold price performance was rather disappointing.

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Inflation

Inflation rose more sharply and appears to be more persistent than central banks expected just a few months ago. In addition to becoming the dominant topic in the capital markets, it has also now received broad media attention. This puts pressure on central banks to show more determination to defend the value of money, which is difficult for a number of reasons.

First, current inflation has less to do with economic overheating that could be cooled by raising interest rates and is instead mainly due to shifts in demand and production bottlenecks that were made worse by logistics problems. At the same time, some sectors of the economy are still suffering, or suffering again, from decreased demand due to the pandemic. Large interest-rate increases would add yet another burden to these companies and endanger the economic upswing, which is still generally fragile, without effectively addressing the origins of the inflation.

A forceful anti-inflation policy with significantly higher interest rates and bond yields would inflict serious collateral damage on the economy and the financial markets.

A true interest-rate turnaround, however, would require a return to positive real yields, that is, an interest-rate level higher than the rate of inflation. This was normal before, but is almost unimaginable today. In particular, the interest burden would be practically unbearable for the heavily indebted countries in the eurozone. In Italy, for example, every one per cent increase in the interest rate would increase budget expenditures by EUR 27 billion per year. Significantly higher interest rates would also cause real-estate prices to collapse and lead to massive problems for lenders. Stock-market valuations and prices would fall dramatically, thereby endangering the retirement pensions of many people (especially in the USA). In the end, the resulting destabilisation of the financial system would also have considerable social consequences that no central banker would risk.

Instead of taking a risk by slamming on the brakes, central banks have to try to show their determination to fight inflation with verbal tightrope acts and cosmetic operations, which will become increasingly difficult if inflation rates remain high. In our Third Quarter Capital Market Report (“Inflation is Back”),

A true interest-rate turnaround would have to accept a return to positive real yields, something that was normal before, but almost inconceivable today.

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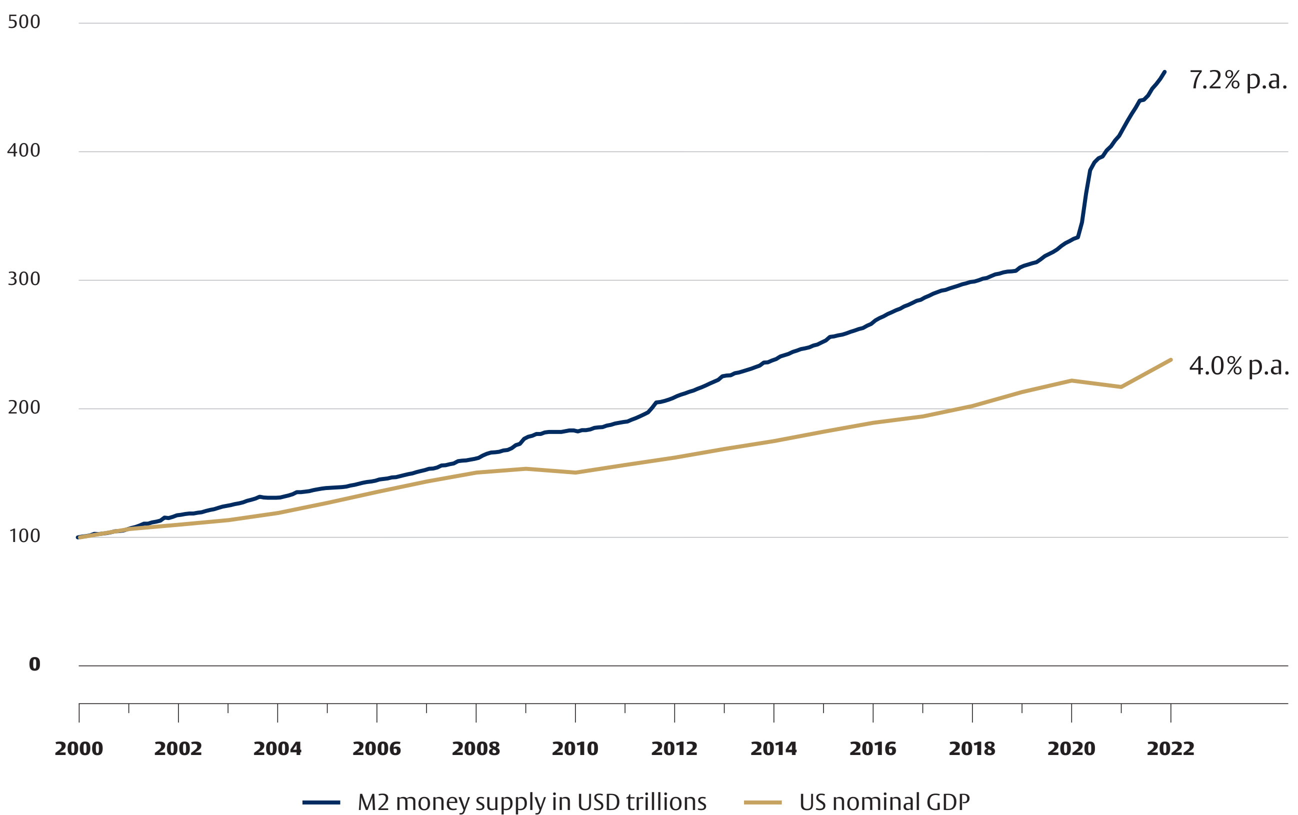
Figure 5

Excess money supply – potentially inflationary

US M2 money supply vs. US nominal GDP (both indexed to 01/01/2000 = 100)



Source: Refinitiv, Flossbach von Storch, data as at 6 January 2022

we stated that inflation is not likely to simply disappear again after the base effects have faded and current supply-chain problems are resolved, because the long-term drivers of inflation – Deglobalisation, Decarbonisation and Demographics (the three "Ds") – are structural in nature. There has also been a large increase in the excess supply of money. In the USA in particular, generous Coronavirus aid programmes have recently increased the M2 money supply considerably faster than nominal GDP (see Figure 5). The resulting excess money supply started increasing slowly after the 2008 financial crisis and then significantly faster during the pandemic.

The money supply has grown at a rate of 7.2 per cent per year since 2000, three percentage points faster than nominal GDP. The rapid growth of 39 per cent since the beginning of the pandemic, or 21 per cent per year, is particularly striking. As long as the money remains in bank accounts and does not affect demand, it will not put pressure on prices. The situation has, however, increasingly changed in previous months, as shown by the decrease in the savings rate (see Figure 6). After depriving themselves in the first phase of the Coronavirus, private households shifted part of their budget from savings to enjoyment. If wages also grow faster in the future,

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consumption would increase even without a change in the savings rate, driving the prices of scarce goods and services further upwards.

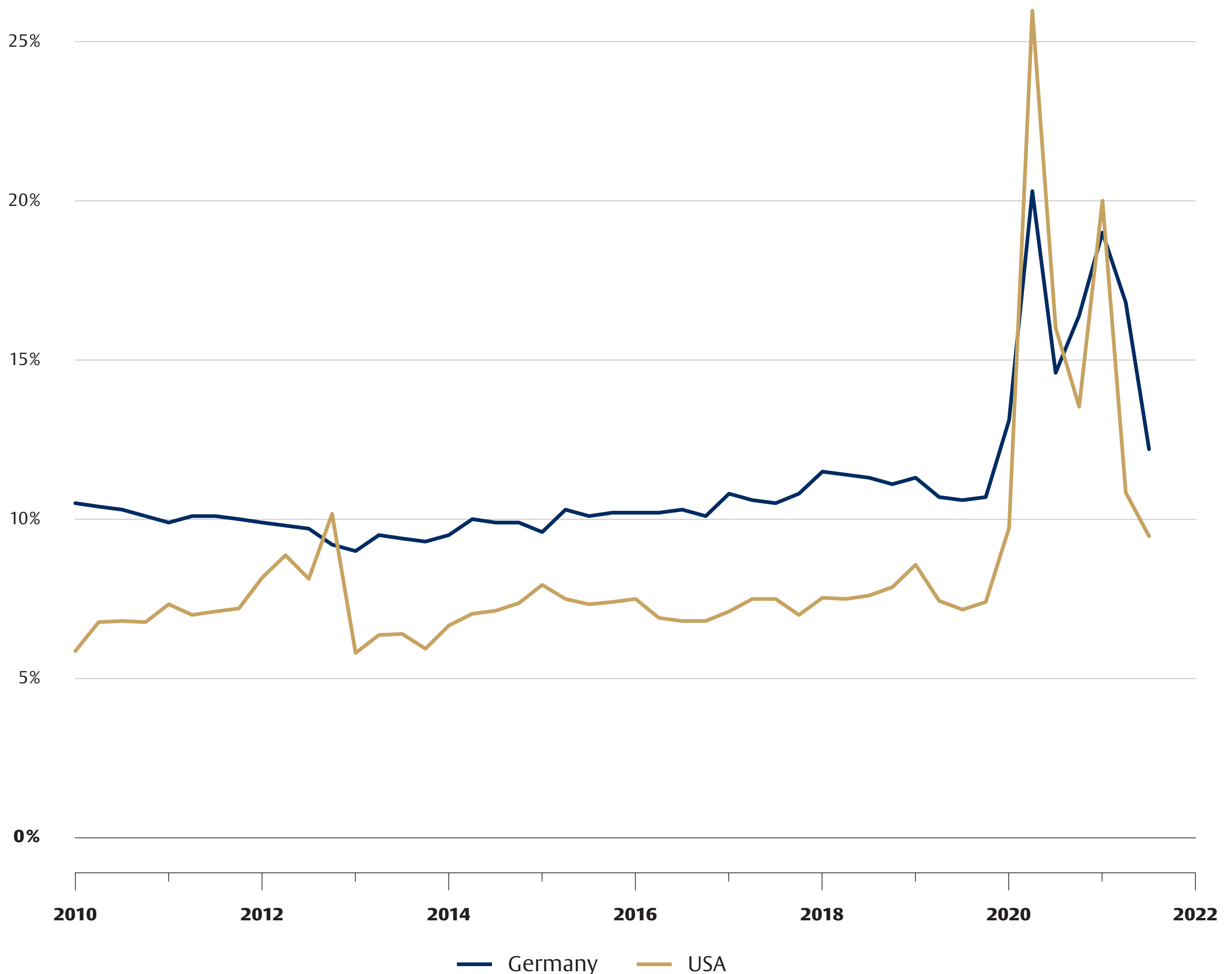
It is also noteworthy how price increases are announced and accepted by customers today as a matter of course.

Something that has long been considered normal for real-estate prices increasingly also applies to the price of goods. This is also apparent from the statements by many companies about being able to implement price increases without much resistance for the first time in decades.

Figure 6

Saving during the crisis

Personal savings rate as a percentage of disposable income



Source: Refinitiv, Flossbach von Storch, data as at 6 January 2022

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INVESTMENT STRATEGY

There is much to suggest that inflation will be considerably higher in coming years than in the last decade. Since a true interest-rate turnaround cannot be implemented, because interest rates would have to be raised back up to or above the rate of inflation, real interest rates will remain negative for a long time to come. While governments can use this kind of financial repression to gradually reduce their debts, savers would lose part of their assets. Even a negative real interest rate of three per cent would decrease the real value of assets by 26 per cent over 10 years. Bonds therefore remain a losing proposition, at least if a simple buy-and-hold strategy is followed. If investors are required by regulation to hold a large part of their assets in bonds, the best they can do is try to increase returns a few percentage points by clever timing. Contrary to their name, inflation-linked bonds do not necessarily provide full protection against inflation.

On the other hand, investors who want to preserve or increase the value of their assets during a long period of negative real interest rates have to invest a significant portion in real assets. Equities and gold are the main liquid assets of this kind. Even though bitcoins are not real assets, since there are limits on how many can be created, they could also turn out to provide long-term protection against inflation if more and more people accept them as a means of storing value in the future. As shown by the extreme price fluctuations, speculation is still the primary motive for investors. However, unlike the “crypto-tulips” that can be created without limits, the number of bitcoin proponents is likely large enough now to make this cryptocurrency a permanent part of many investors’ portfolios. Gold, on the other hand, is relatively boring but has proven its worth as protection against inflation for thousands of years, something the new competition from bitcoins is unlikely to change.

Equities, however, remain the focus of anti-inflation strategies. Although prices rose considerably last year, company earnings also grew significantly. US equities have a price-to-earnings (PE) ratio of 26 when earnings for the previous 12 months are used (based on the S&P 500 index). If one looks to the future and uses expected earnings for 2022, which are 19 per cent higher, the PE ratio drops to 21. Although this is still a high value compared to the past, the fact that the current level of interest rates is much lower today also has to be taken into account. The picture is naturally similar for the MSCI World index, since almost 70 per cent of the index consists of US stocks. With a PE ratio of 15, the shares in the DAX index almost look like a bargain in comparison. This is mainly due to a chronic lack of large growth companies in the technology, consumer goods and financial services sectors and a very low valuation for automotive stocks, which investors are currently only willing to buy at a price that is six to seven times current annual earnings.

Since company valuations have to be based on future earnings or cash flows, estimates of future earnings or growth potential must be reasonably accurate and discounted using an appropriate risk premium. This is easier for established companies with steady, predictable growth, such as Nestlé, Procter & Gamble and Microsoft, than relatively young growth companies whose path to success is highly uncertain. As a result, future prospects that often appear highly attractive, but are relatively uncertain, also have to be discounted with a larger risk premium than companies with highly predictable growth.

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A return to reality for high-flyers during the pandemic

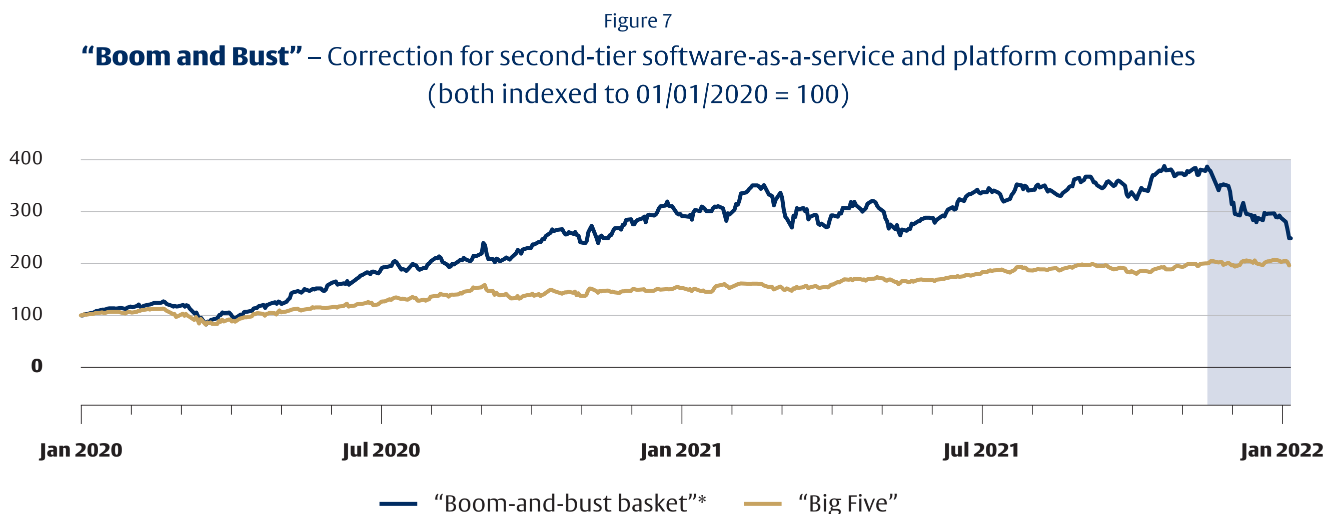
The risk premium for uncertain future prospects is often forgotten in times of great euphoria when there no longer appear to be upside limits. Last year, for example, many young technology companies that were still relatively young were valued at a price-to-sales ratio of 50 to 100 and were suddenly among the big players based on market capitalisation. However, extreme high expectations also mean a long way to fall, as shown by recent price losses for stocks that were high-flyers during the Coronavirus boom. Price reductions of more than 50 per cent were not uncommon and even went as high as 70 to 80 per cent for some prominent companies, such as Zoom and Peloton.

A representative basket of 20 medium-sized software and platform companies we prepared shows this boom-and-bust phenomenon as compared to the relatively continuous price trend followed by the "Big Five": Apple, Microsoft, Alphabet, Amazon and Meta Platforms (see Figure 7).

The medium-sized stocks in the "boom-and-bust basket" have an average market capitalisation of around USD 33 billion, have already achieved strong positions in their market segments, generate significant revenues, and grow at a rate that is far above average, as shown in Figure 8. This could lead

Figure 7

"Boom and Bust" – Correction for second-tier software-as-a-service and platform companies (both indexed to 01/01/2020 = 100)



* Equally weighted basket of 20 tech stocks.

Sources: Refinitiv, Flossbach von Storch, data as at 6 January 2022

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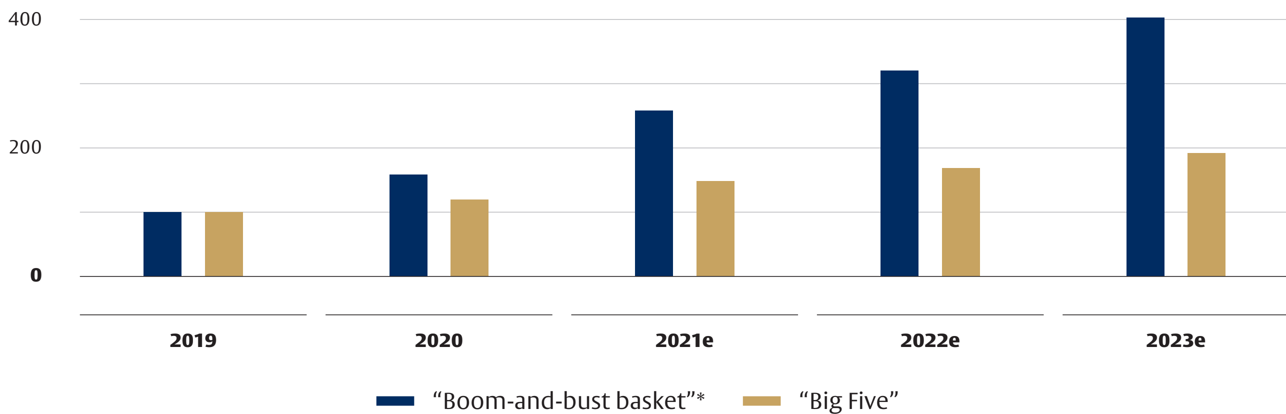
Figure 8

"Boom" – Historical and forecast revenues (indexed to 2019 = 100)



* Equally weighted basket of 20 tech stocks.

Sources: Bloomberg, Flossbach von Storch, data as at 6 January 2022

Flossbach von Storch scenario analysis. Actual future performance may differ from the assumptions made here.

to buying opportunities if the correction continues and share prices reach a level that also provides an attractive risk-return ratio for long-term investors.

The hype around start-ups in the electric car sector, which now also appears to be cooling down, shows the extent of recent investor euphoria. On 9 November, US electric vehicle manufacturer Rivian went public at an IPO price of USD 78. Only five days later, the share price had almost doubled, leading to a market capitalisation of USD 153 billion even though the company had not delivered a single car just a few months before. This meant that Rivian's market capitalisation was twice as high as car manufacturer BMW, which likely generated record earnings of more than EUR 10 billion in 2021. Lucid, an electric car manufacturer arising from a SPAC, also reached a market capitalisation of more than USD 90 billion at the end of November without having delivered a single car. Investors are clearly electrified by the prospects and expect every electric car manufacturer to become the next Tesla and established car manufacturers to disappear from their screens.

The fundamentals hardly play any role in their considerations – only battery-powered speculation is important. Even though market forces brought Rivian's share price back down to USD 104 by the end of the year, this still represents an impressive market capitalisation of USD 93 billion. After all, the company also plans to sell cars this year.

The existence of speculative stocks like these does not mean, however, that technology shares as a whole are completely overvalued and face the same fate that occurred when the tech bubble burst in the period from 2000 to 2002. The technology-heavy Nasdaq Composite index, consisting of more than 3,000 stocks, fell almost 80 per cent at that time. Unlike then, many technology companies now have relatively moderate valuations, especially if the above-average growth potential created by the ongoing digitalisation of the entire economy is taken into account. This is also true for other sectors, such as financial service providers, the industrial sector and medical technology, where software and hardware are increasingly merging.

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Portfolio diversification in a low interest-rate environment

Since bonds provide almost no risk buffer in a low interest-rate environment, intelligent portfolio diversification must be used to compensate for this disadvantage as much as possible. Although gold and the shares of gold producers have shown they can provide good risk compensation during some corrections, such as the beginning of the pandemic, this is no guarantee for the future.

We therefore aim for a balanced mix of high-growth and robust companies in our equity allocation. The latter have predictable cash flows and attractive dividends and include, above all, traditional equities in the consumer goods and pharmaceutical sectors. Shares of highly profitable cyclical companies with low valuations, such as those in the chemical and automotive sectors, that are able to pass higher prices on to their customers due to their market position, are also a sensible component for a portfolio aimed at real asset growth in times of rising inflation.

This allows the effects of unexpected negative events to be limited, while still taking advantage of opportunities created by unexpected positive events. Finally, diversification like this also provides the best protection against human fallibility, something that every investor has to live with. Unexpected events include "unknown unknowns", i.e. events that are not known or not considered. They also include "known unknowns", i.e. events that are known, but whether they will occur is unknown. Central bank policy is probably the most important known unknown. By autumn last year, financial markets had lulled themselves into a sense of security that central banks felt inflation was just

Since bonds provide almost no risk buffer in a low interest-rate environment, intelligent portfolio diversification is more important than ever – including in the equity allocation, where we aim for a balanced mix of high-growth and robust companies.

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temporary and would continue their loose monetary policy for a long time to come. 2022 could therefore be a litmus test. If inflation turns out to be higher and more persistent than previously thought, central banks could feel forced to tighten monetary policy. In the base scenario outlined above, we assume these measures would be more cosmetic in nature or, loosely based on the words of German comedian Karl Valentin, that central banks would not dare to act: *"I really would have liked to, but I didn't trust myself to allow it."* But if they do act, for example because the economy and labour market perform better than expected, then the safety net that central banks have set up to protect markets would provide less support. That, in turn, would increase the likelihood of a setback for stocks that have benefited strongly from the low level of interest rates. Although we don't consider this likely, based on the reasons above, it cannot be completely ruled out. The same would apply to the opposite situation of an unexpected global economic slowdown due to a new, more dangerous virus variant that would lead to global lockdowns or the closure of production facilities and ports in China.

What is therefore important is that not all securities in a portfolio suffer from a particular scenario and some might even benefit from it. Not all sectors, however, need to be represented in the portfolios. For a variety of reasons, oil, coal, nuclear energy, conventional banks and armament companies are traditionally not among our preferred sectors. Although this can lead to a temporary loss in performance, as in the year just ended, it should pay off in the long term. Even the politically motivated decision by the EU Commission to classify nuclear energy as sustainable will not change this.

If inflation turns out to be higher and more persistent than previously thought, central banks could feel forced to tighten monetary policy. This would have consequences for the capital markets.

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CONCLUSION

Inflation is no longer a temporary phenomenon. It has replaced the pandemic as the most important topic in the financial markets, as it puts central banks under pressure to show more determination to defend the value of money. Even the ECB now expects inflation of 3.2 per cent in 2022, a rate significantly higher than its target level. Its hands are tied, however, since a true interest-rate turnaround would create major problems for the eurozone. The Fed, on the other hand, has already changed course and begun scaling back its expansive policy. The financial markets are already expecting several interest-rate increases, as can be seen from the significant drop in the price of growth equities with high valuations, whose earnings far in the future are now losing value.

But even the Fed does not act in a vacuum. Increasing interest rates too quickly and too much would not only cripple the US economy, it would also endanger the economic recovery in the rest of the world. Raising the interest rate to the level of inflation or above should not be expected, even if the US economy is booming. Real interest rates will therefore remain negative, which makes bonds appear less attractive compared to equities, even at somewhat higher yield levels. Soundly financed companies that benefit from good economic growth and are able to pass higher prices on to their customers will be able to handle a small increase in interest rates.

The possibility of central banks taking a tougher stance will likely remain a constant concern in the stock markets and occasionally lead to larger market setbacks than in the year just ended. However, in view of the permanently higher level of inflation, this is not a reason for long-term investors to abandon a strategy based on real assets and, therefore, real asset growth due to a fear of temporary fluctuations.

Dr Bert Flossbach

Cologne, 7 January 2022

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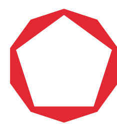

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