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Equities and the inflation scare

Tamás Menyhárt



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At the end of March, I wrote about [what implications higher inflation expectations and higher yields had for certain sectors in the equity space](#).

Two months later, this topic remains the most heavily discussed one on the market. The recent global fund manager survey by *Bank of America* found that inflation was cited by 35% of participants as the biggest tail risk, ranking number one ahead of a possible taper tantrum, which is seen as a first step by central banks to remove some of the excess liquidity.

Even though an overshooting in inflation is a concern for equities and economies all around the globe, currently the focus is primarily on price increases in the US, due to the large size of the economy and the fact that the rebound in GDP has been one of the strongest globally. While the Fed has so far maintained its view that any uptick in inflation above its target of 2% will prove to be transitory, investor's doubts were amplified by the April CPI data (consumer price index, a widely used metric to measure inflation), which increased by 4.2% year-on-year, far above expectations. Also, a recent study showed that on average the word "inflation" came up more than once per earnings call in the US this season, highlighting the increased importance of the topic.

The increase in the US consumer price index in April came in much higher than expected
Source: Refinitiv Datastream

European banks helped by higher bund yields

10-year yields in the US have been hovering around 1.6% since March, consolidating the upward move made since the beginning of the year. Recently, it was the European government bonds which reacted more visibly to increased inflation expectations. The German bund yield touched minus 10 basis points in May, the highest level in two years. This helped European banks extend their gains and make them the best performer in the Stoxx 600 this year. The sector has now basically regained all its losses caused by the pandemic, while US banks are trading at fresh all-time highs. In general, banks benefit from higher yields because it allows them to earn more interest both on their loan book and their bond investments.

The 10 year German government bond yield is at its highest level in two years
Source: Refinitiv Datastream
Note: Past performance is no reliable indicator for future performance.

Gold rebounding

Another strong performer as of late was gold, gaining more than 11% from the lows reached in March. The precious metal – which rallied 25% last year, but performed rather poorly in 2021 – came back into favor as a rising inflation rate pushed real yields (= nominal yield – inflation rate) lower. Since gold does not pay a dividend, lower real yields reduce the opportunity cost of holding the precious metal, thereby making it a more attractive investment. The weakening of the USD – the currency in which most commodities are quoted – also played its part in the rebound of the gold price.

The gold price gained more than 11% from its recent low
Source: Refinitiv Datastream
Note: Past performance is no reliable indicator for future performance.

Q1 earnings crushed expectations

Even amid all the worries about inflation, major equity indices such as the S&P 500, MSCI World or the Stoxx 600 are trading around their all-time highs reached in May. Company earnings in the first quarter showed a very encouraging picture and came in way ahead of analyst expectations. In the US, more than 80% of companies beat expectations, and earnings grew by more than 50% year-on-year in absolute terms. In Europe, there are still many companies left to report, but out of those who already did, earnings grew by over 90%, also far better than expected. Compared to the strength in earnings, the overall stock market reaction was rather muted, as investors already discounted a lot of the positives beforehand.

Many of the S&P 500 sectors surprised very positively on earnings (horizontal line), but saw muted stock price reactions on the day of the results (vertical line)
Source: Bloomberg

The positives still outweigh the negatives

Currently our perception is that even though there are risks on the horizon, as explained above, the positives still outweigh the negatives going forward. After the strong earnings surprises, analysts will be busy in the coming months to upgrade their expectations. The vaccine rollout is progressing well, and now that Europe's vaccination rate has caught up, it looks increasingly likely that most parts of the developed world will enjoy a relatively normal summer, which will give consumers the opportunity to spend parts of their built-up savings and to satisfy their pent-up demand. Also, companies will likely start spending more if they face an increasing demand, which can add to the ongoing economic recovery. We maintain our view that a relatively balanced portfolio is warranted at this stage, whereby sectors which stand to benefit from higher inflation (e.g. banks) should be overweight.

ERSTE REAL ASSETS: A fund to cushion inflation

Those who want to guard against the emergence of inflation have several options to do so. Real assets, such as equities, real estate and gold, are one option.

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[1] Acquisition usually in the form of exchange traded commodities (notes). Physical delivery of the aforementioned precious metals is not permitted.

[2] The portfolio positioning of the fund corresponds to the planned positioning at the fund launch at the editorial deadline. Within the scope of active management, the portfolio positioning mentioned may change at any time.

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Tamás Menyhárt

Senior Fund Manager, Erste Asset Management