GADD
WEALTH MANAGEMENT

Market Insight

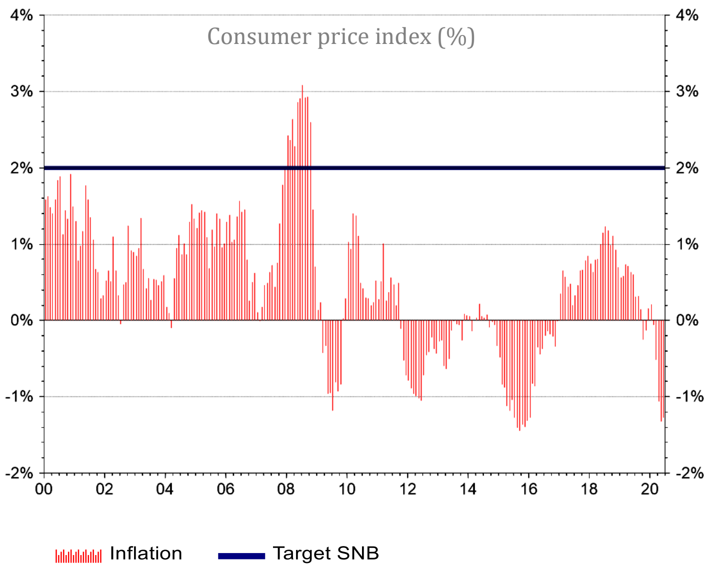
SUMMER 2020

Inflation : a little, madly, not at all ?

Inflationary or deflationary Covid-19? The debate is raging. The fact that there is - for the time being - no inflation at all is an unexpected windfall for central banks, that can inject liquidity at any time, which the financial markets are happy to accept. Certainly, a little inflation would not displease the governments, at a time when the Covid19 bill is getting heavier and heavier every day. But the micro-dosage of debt monetization is a perilous exercise in which the "not at all" can turn into "madness" in the blink of a butterfly's wings.

After infecting the growth of the world economy, will Covid-19 trigger the inflation virus? That seems difficult to envisage, given the unprecedented scale of the global recession. In Switzerland, it would even be disinflation (a decrease in an inflation rate that remains positive) or even deflation (negative inflation rate together with a drop in economic activity) that should be brought to the fore, as evidenced by the graph below.

1. Technically, Switzerland is in deflation



Source: Refinitiv Datastream / MacroGuide

Inflation : not good, nor bad, but ugly ?

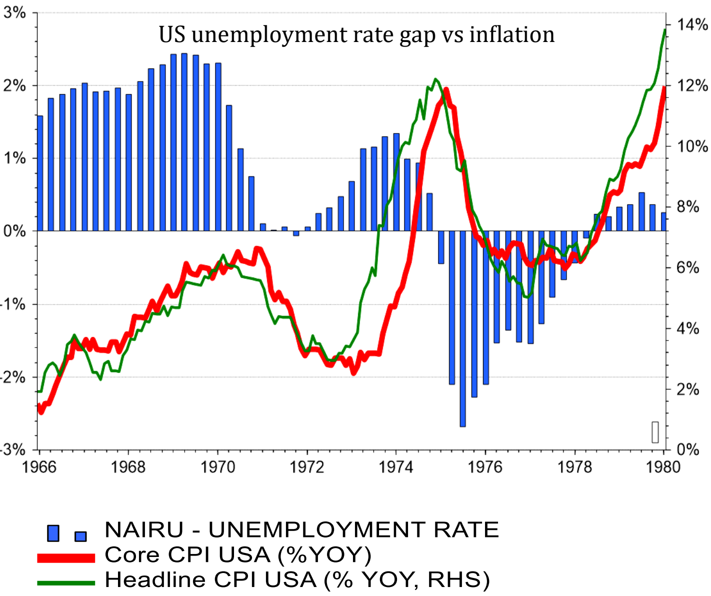
In order to alleviate the burden of public debt, which is likely to increase with the Covid19, a little inflation would be desirable.

But what kind of inflation are we talking about? To borrow from the famous visions of Tuco, the ugly guy in Sergio Leone's cult film "The Good, the Bad and the Ugly", the world of inflation can be divided into two categories: the "good", which is linked to unbridled economic growth, and the "bad", which stems from rising production costs. That's forgetting about the ugly type, which deserves its name. But let's take a closer look.

Good inflation is what we dream of. And with good reason. The overheating that drives up prices is to be found in booming economies. Consumers are spending at breakneck speed, producers are unable to keep up with their shopping frenzy and ... prices start climbing. Nothing could be easier for a central bank than fighting this type of inflation. All it takes is to raise interest rates until consumers get down on one knee and are cured of their buying fever. Good inflation was in abundance in the 1970s. Chart 2 shows that the unemployment rate in the United States spent much of that decade below the Non Accelerating Inflation Rate of Unemployment (NAIRU), namely the non-inflationary full employment threshold. This was the end of the "glorious 30" that marked the post

-war period, when GDP growth outpaced the increase in government debt, the real burden of which was contained by ... inflation. Except that a little inflation is good, but too much is too much: at 10%, the tolerance threshold was crossed in 1979, and the Federal Reserve entered the waltz of massive interest rate hikes. They reached 19% (yes... you read that right: 19%!) in 1982 and inflation, the good kind, was knocked down.

2. « Good inflation » goes back to the overheating of the 1970s

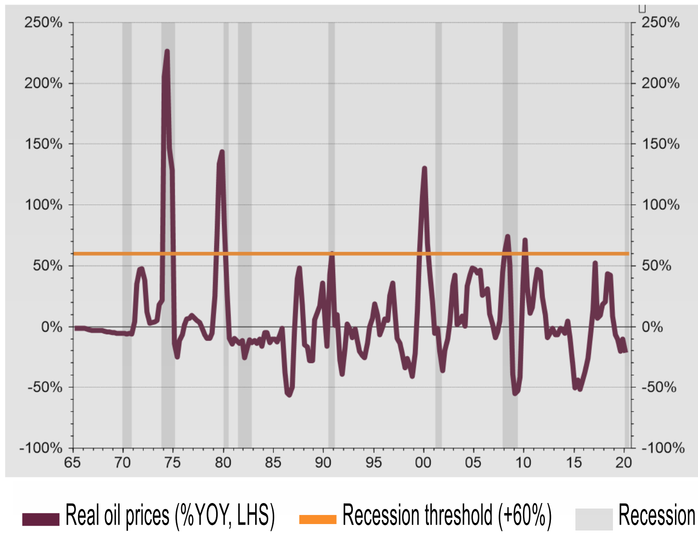


Source: Refinitiv Datastream

Next comes the **bad inflation**: that which is linked to tensions of energy prices. Oil is the main underlying factor behind changes in production costs. These price tensions can occur in a weak economy, quite distinct from full employment which characterizes overheating. It only takes a cartel of oil producers to quadruple the price of an oil barrel from one day to next for prices to soar, as they did in 1973. Should a restrictive monetary policy be used to counter this type of "cost-push" inflation? Certainly not, it's heresy! Raising interest rates when a country is experiencing insufficient domestic demand and consumers are feeling the impact of higher pump prices? This is the best way to bring about a recession, and that is exactly what happened with the Fed's untimely tightening following the oil shocks of the early 1970s.

The big difference between good inflation and bad inflation is that the former is the consequence of an overheated economy, while the latter is the cause of recessions.

3. « Bad » inflation : cause of recession



Source: Refinitiv Datastream

We are left with the least Catholic of the three types of inflation, the **ugly one**. It arises from an excessive issue of money, aimed at financing the state's deficits. It is the most terrible of the three types of inflation, because it manifests itself without warning and, above all, can turn into hyperinflation. Examples include Germany in 1923, Hungary in 1946, Zimbabwe in 2008 and ... today: last month Zimbabwe experienced an inflation rate of over 1000 %! All in all, the 20th century has seen twenty-nine cases of hyperinflation, where prices could double every twenty-four hours.

The thirtieth period of known hyperinflation dates back to the French Revolution, under the regime of "assignats", a paper money with a plunging value that merchants had to accept under penalty of a fine, then imprisonment, and even death in the event of repeat offences.

4. The world has been seen 30 cases of hyperinflation linked to excessive issuance of money

Country	Year(s)	Highest inflation per month %	Country	Year(s)	Highest inflation per month %
Argentina	1989/90	196.6	Hungary	1945/46	1.295×10^{16}
Armenia	1993/94	438.04	Kazakhstan	1994	57
Austria	1921/22	124.27	Kyrgyzstan	1992	157
Azerbaijan	1991/94	118.09	Nicaragua	1986/89	126.62
Belarus	1994	53.4	Peru	1988/90	114.12
Bolivia	1984/86	120.39	Poland	1921/24	187.54
Brazil	1989/93	84.32	Poland	1989/90	77.33
Bulgaria	1997	242.7	Serbia	1992/94	309 000 000
China	1947/49	4208.73	Soviet Union	1922/24	278.72
Congo (Zaire)	1991/94	225	Taiwan	1945/49	398.73
France	1789/96	143.26	Tajikistan	1995	78.1
Georgia	1993/94	196.72	Turkmenistan	1993/96	62.5
Germany	1920/23	29 525.71	Ukraine	1992/94	249
Greece	1942/45	11 288	Yugoslavia	1990	58.82
Hungary	1923/24	82.18	Zimbabwe	2007/08	10.96×10^{10}

These 30 known periods of hyperinflation share a common feature: they have occurred under "discretionary" monetary regimes, where money is issued by a central authority without any limits, unlike those which prevail under the gold standard. On the other hand, hyperinflation has always occurred in countries with poor public finances. Historically, the monetization of government debt has always been the primary cause of hyperinflation.

The reason for this is very simple: money has ceased to be fiduciary because its users have lost confidence ("fiducia" means "trust" in Latin and ... Italian) in its value as the quantity of money issued by the central bank has taken the lift to fund public debt. Cash is quickly converted into basic necessities for fear of seeing their price rise, a spiral that may quickly become self-fulfilling.

Some economists pinpoint that hyperinflation is caused by the devaluation of a currency against its peers. And since all government states must now pay the bill for Covid-19, resorting to central banks to do so is necessarily painless. No currency devaluation, so no risk of hyperinflation? Personally, I don't really believe it. It is true that we have never known in history a period of global hyperinflation. But imagine that this "helicopter money" that is much talked about today is actually implemented, and money starts to actually fall from the sky, everywhere in the world, like the $1,000 check that President Trump sent to every American citizen: what would be your first reflex? For my part, I would hasten to convert this windfall into real goods and services, thus contributing to their increase in price.

Around the world, central banks are exploding the money supply. In developed countries, it has increased fivefold since the 2008 crisis. Since the emergence of the Coronavirus, the Fed's balance sheet has grown from $4 trillion to more than $7 trillion. Central banks feel encouraged to pump prime the economies by the lack of inflationary consequences of their ultra-expansive policies.

But beware, ugly inflation is like the bottle of ketchup that you desperately shake on your plate. The epilogue is often brutal.

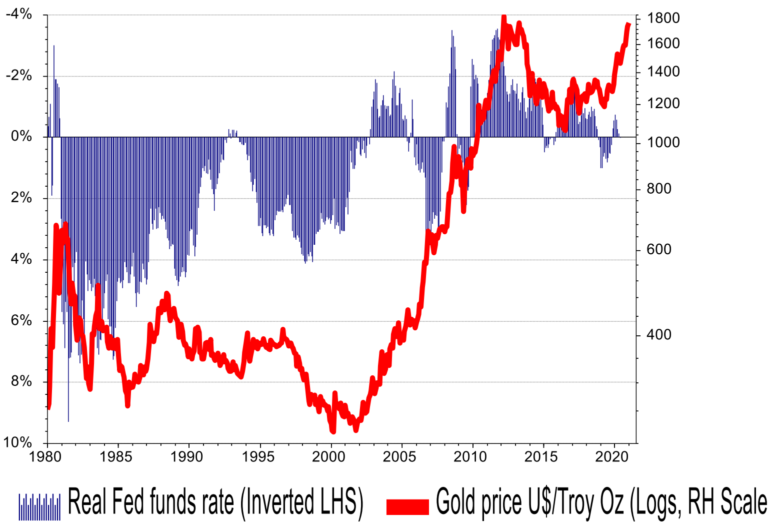
What impact on the financial markets ?

How do financial markets cope with these different types of inflation?

In that it reflects very healthy economic growth, the equity markets enjoy the good inflation. We will have to wait a few years before considering it. As far as the bad inflation is concerned, it is of course oil and, more generally, raw materials that benefit from it, as well as oil-producing countries. Since China became a member of the World Trade Organization in 2001, the sharp increase in its energy imports has meant that oil price variations have become more closely linked to the cycles of the world economy. As such, inflationary pressures from the price of black gold seem unlikely.

What about the ugly type? Emanating from over-issuance of money, the best way to guard against it is to invest in gold. It's a good thing that today we are "paid" to hold it: if we remember that the cost of holding the yellow metal is the real return we forgive on cash, such opportunity cost is negative today. It may even remain so for a long time. Didn't Fed Chairman Jerome Powell say on June 10 that we are not even thinking about thinking of raising interest rates?

5. Free gold : a diversifying asset



Source: Refinitiv Datastream / MacroGuide

Michel Girardin, *Senior Economic Advisor*

Money-market and fixed-income

The gradual lifting of lockdowns since the month of May in the US and the main developed economies in Europe has triggered a resurgence in global economic activity. US indicators confirm the recovery in manufacturing activity, while the acceleration in job creations should help satisfy pent-up consumer demand. In Europe the business climate has improved and, in Asia, the Chinese economy is almost completely back to where it was at the start of the year. But the pandemic isn't over; it is still wreaking havoc, pending an effective and approved treatment. Monetary and fiscal interventions since mid-March headed off a financial crisis and reassured investors. With no inflation to worry about, government bond yields held at low levels, near 0.7% for the 10-year US yield and -0.4% for the 10-year Bund, while spreads narrowed throughout the yield curve. We reinvested our cash gradually in active strategies on certain segments of the curve. Bonds account for 36% of the balanced portfolio, including 5% in cash instruments, 3% in short-term products, 10% in sovereigns, 8% in corporate investment grade, 5% in high yield, 2% in emerging debt, and 2% in convertibles.

Equities

The rebound in global economic activity and monetary and fiscal stimulus measures quickly restored the markets' confidence in the outlook for a return to normal. The IMF's forecasts released in late June are for a 4.9% global contraction in 2020, followed by 5.4% expansion in 2021. In reaction to this encouraging outlook, US equities have clawed back most of their losses, with a year-to-date decline of just 3%. With its lighter weighting in the digital economy and its heavier weighting in financials, Europe has rallied less and is now down by 12% over the same period of time. This produced an automatic increase in the equity weighting of our balanced portfolio to its neutral 50% allocation, including 18% in the US, 18% in Europe, 4% in Japan, and 8% split mainly among China, India, Korea, Taiwan, Brazil and Australia. Among the main sectors represented, technology and healthcare have made a big contribution to performance, while financial services and industry have done less so. The performance gap between growth and value stocks widened during the market rally, thus demonstrating investors' continued keen interest in growth stocks. Likewise, large caps have outperformed small and mid caps. We also dialed back our tactical hedges.

Currencies

The dollar, already weakened by the Fed's aggressive rate cuts in March, traded lower on the prospect of a gradual recovery in the global economy. The dollar's decline boosted the euro and gold. Our USD tactical allocation now accounts for 18% of the balanced portfolio. We shifted our currency allocation from the yuan (2%) to the Mexican peso (1.3%). Yen is at 2% and gold, 5%.

Alternative

Alternative investments accounted for 9% of the balanced portfolio. We reduced the number of positions and added to discretionary strategies. Equity Market Neutral now accounts for 3.5% of the allocation, Global Macro 2%, Multi-Strategy 1% and diversification and protection strategies 2.5%. We continue to target volatility controlled of about 3%, a low correlation to traditional assets (0.24/equities and 0.39/bonds), and a return of about 300bp above the risk-free rate.

Outlook

We had underestimated the multiplier effect on the markets of the unprecedented stimulus measures put through since March. The markets are being driven less by macroeconomics and more by monetary and fiscal considerations. The unheard of and extraordinary fiscal injections worldwide, which have now surpassed 5000 billion dollars, or almost 6% of global GDP, have been made possible by central banks' accommodative financing conditions. We are seeing a new phase of reflation in real assets, which could send the indices even higher, as long as the current recovery is not derailed by the pandemic or geopolitical tensions. In the short term, high valuations would seem to point to a summer pause.

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