Higher but ultimately contained prices

Marketing material

Inflation rates will likely stay elevated in 2022 and above central bank targets due to unfolding supply impasses. While price pressures are still expected to weaken as the pandemic recedes, abating structural disinflationary forces will foster an environment of higher inflation uncertainty and skew price pressures to the upside relative to the past cycle.

The global economy continues to feel the pandemic-induced ruptures to consumer demand and supply chains, as annual consumer and producer price inflation remain at multi-year highs in most economies. Indeed, both the Federal Reserve and the European Central Bank have recently upped their inflation forecasts, suggesting that even central banks have had to acknowledge that current price pressures are stronger and longer lasting than originally anticipated.

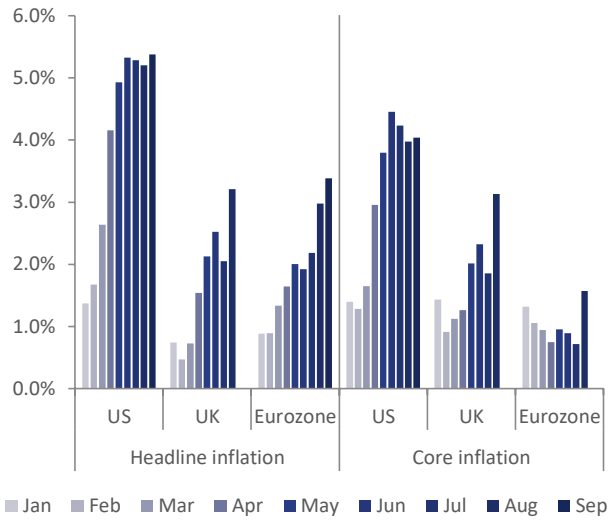
These dynamics have not only occurred in headline inflation, which is prone to cyclical swings in energy and food prices, but also in core inflation readings. Consequently, while the world is seeing the highest inflation uncertainty in years, the debate around the nature and the duration of these price surges, i.e. whether they are transitory (and will eventually pass) or more permanent due to second-round effects, rages on. Our base case remains an environment where inflation will settle below current levels but above central bank targets next year. But the risks are skewed to the upside at this stage.

A multitude of shocks

On the supply side, three factors are driving prices: labor scarcity, supply impasses (e.g. shipping bottlenecks, semiconductor scarcity etc.) and energy shortages. On the demand side, two factors are essentially at work: a stimulus-induced demand surge (in goods and services) and improving wage bargaining power due to recovering labor markets. As these numerous shocks are occurring simultaneously, the risk of second round dynamics, where e.g. energy prices feed into wages and ultimately into higher inflation expectations, has thus been rising. However, many elements that are driving prices higher are still primarily linked to the pandemic - and the latter could come to an end surprisingly quickly. At the current vaccination pace and barring the emergence of a vaccine-resistant virus mutation, the world in GDP-weighted terms could reach heard immunity in about four months.

Against this backdrop and after carefully disentangling the shocks, it is still reasonable to assume that most of the current price drivers are indeed likely to weaken over the course of 2022 given that they are in some shape and form tied to the pandemic, as we will discuss.

Graph 1
Inflation rates in developed markets are at cycle highs
(Annual changes in headline and core inflation in 2021)



Source: Refinitiv, LGT Capital Partners

The labor market

The supply of labor is still suppressed by the pandemic to some degree: People continue to incorporate health concerns into their working decisions and skills of hitherto furloughed labor need to be re-matched to demand. Further improvement on the labor front is likely as virus cases continue to abate, especially in the US, where generous unemployment benefits have resulted in voluntary unemployment in lower wage segments. As schools reopen and vaccination rates among adolescents rise, labor force participation of child caretakers (predominantly women) will arguably rise as well. Although virus waves are still likely to temporarily bog down the supply of labor occasionally, the degree will lessen as the pandemic gradually subsides to a

flu-like reoccurring disease due to rising vaccination rates and better medical treatment options.

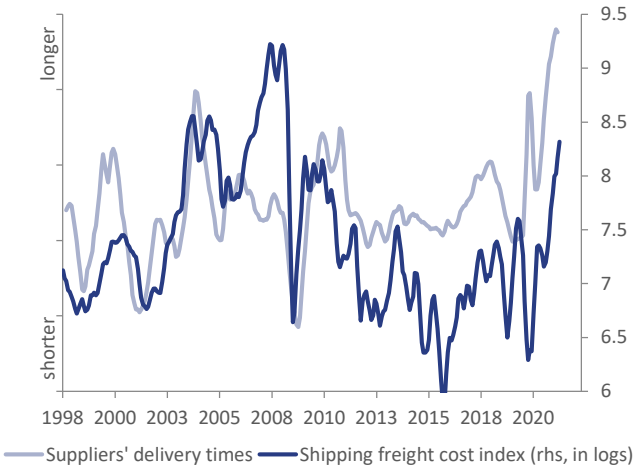
Supply impasses

The outlook regarding supply impasses is less sobering. For example, labor shortages and pandemic-related understaffing in the shipping industry intensify congestions at the ports of departure and arrival. As companies' inventories are largely depleted after close to two years of pandemic-related disturbance, even a relatively quick end to COVID will only be felt with a major delay in global supply lines, suggesting continued price pressure on that front until new production and transport capacity comes online. The United Kingdom is particularly at risk from these dynamics, because the Brexit-induced decoupling confronts the region with yet another major supply shock that needs to be managed.

Graph 2

Suppliers are facing global impasses and higher costs

(Suppliers' delivery times and Baltic Dry Index, smoothed)



Source: Refinitiv, LGT Capital Partners

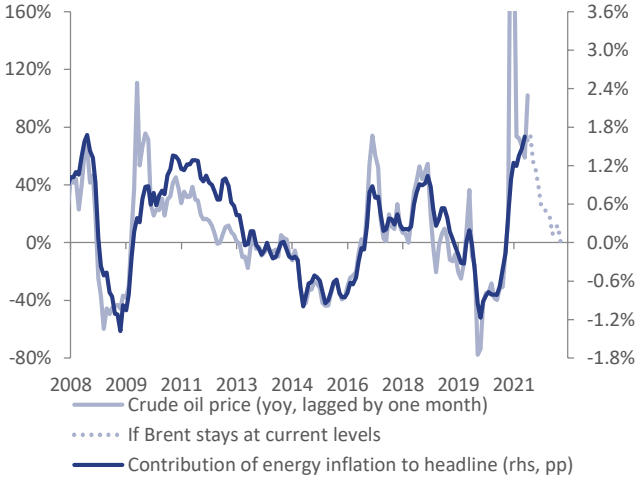
Energy price inflation

As of late, signs of a looming energy crisis are appearing, driven by an interplay of green energy policies, frictions from the pandemic recovery, weather effects and geopolitical developments. Clearly, the transition toward sustainable energy has the longest lasting (and deliberately permanent) implications, as it entails a policy-commanded supply shift. The recent price surges, however, were exacerbated by low storage volumes and cold weather in both China and Europe, as well as arguably political considerations around the recently finished Nordstream 2 pipeline between Russia and Germany and import bans of Australian coal in China. This supply shock is further exacerbated by a substitution effect, as utilities accommodate rising heating demand by switching from record-high priced natural gas and coal to running older but currently cheaper oil-fired units. Statistically speaking, the boost from energy will go into reverse next year due to base effects and lower oil and gas prices (according to future markets), as government and utilities are currently rushing to expand supply again.

Graph 3

Higher energy prices are boosting Eurozone inflation

(Oil prices and contribution of energy inflation to headline)



Source: Refinitiv, LGT Capital Partners

Reopening inflation

On the demand side, reopening inflation (i.e. demand for goods and services that is related to pandemic distortions) remains high. Generous government stimulus payments combined with stay at home orders have severely skewed consumer demand patterns. Initially toward (electronic) goods, thus exacerbating chip shortages and creating adverse price moves in other categories, e.g. in used cars.

Increasingly, however, that demand has tilted toward services, as governments move to scrap their pandemic for restaurants, cinemas etc., and tourism and travel recovers. These catch-up dynamics are unlikely to persist for much longer. After all, people are unlikely to up their IT infrastructure and refurbish their homes every year. And while you can opt for pricier holidays or restaurant meals, such "luxury" spending is unlikely to outlast the end of your pandemic-induced savings. Thus, once these catch-up dynamics have played out, demand in reopening categories, like used cars, airline fares, hotels and motels, etc. will likely fall back to pre-pandemic trend patterns. Ultimately, base effects in reopening categories will then drive prices lower. In fact, given that pandemic restrictions are already at record lows again (i.e. the reopening has progress far already), reopening inflation is unlikely to rise meaningfully from here.

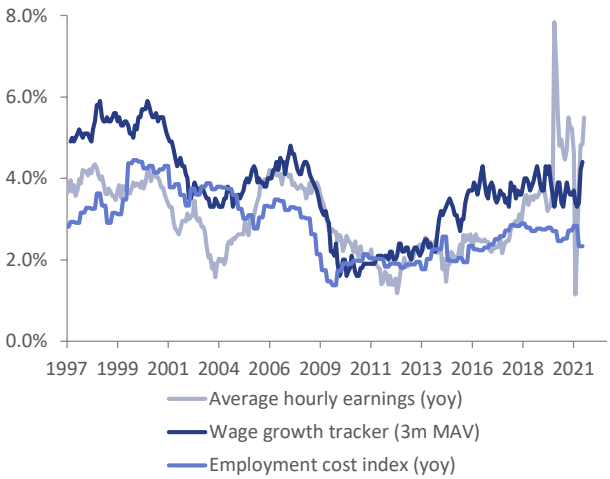
Wages

Wage pressures remain the wild card in the inflation outlook. Firstly, traditional and timely measures of wage growth like average hourly earnings are highly sensitive to changes in the labor force composition and thus still heavily distorted. Initially, the sudden lapse of low wage jobs (due to stay at home orders) boosted the average, giving semblance of wage growth during the initial stages of the pandemic. Now, ongoing distortions in the labor force make it hard gauge to which extent wage growth normalizes alongside the labor force. Secondly, the impact of seasonal adjustments – usually an essential step to improve informational content of data releases – is virtually

unclear in a year that is far away from evolving along seasonal patterns.

While less distorted but lower frequency data does not (yet?) corroborate the signal of rising wages evident in higher frequency readings, company surveys and anecdotal evidence from media reports strongly suggest an ongoing meaningful pick-up in wage dynamics too. Moreover, wage bargaining power has risen given the aforementioned labor shortages. Ultimately, the extent of labor market slack and the evolution of unit labor costs[1] will determine whether the cyclical pick-up could morph into more structural wage pressure. In this regard, the situation in the Eurozone and the UK seems less concerning compared to the US. But even the US could live with higher wages if they rise alongside productivity.

Graph 4
Wage growth is picking up in the US
(US wage growth according to different indictors)



Source: Refinitiv, LGT Capital Partners

Where to go from here?

Continued shortages that are likely to persist well into the next year and adverse energy price movements have skewed the inflation outlook further to the upside. However, regional discrepancies abound. Price pressures are likely to remain most pronounced in the US and the UK.

In the former, a closed output gap will perpetuate wage pressures more directly into price dynamics in 2022. Another element that will also contribute positively is shelter. Shelter inflation accounts for about 40% and 16% of the US core consumer price index and the core personal consumption price index, respectively. The latter is the Federal Reserve's favored inflation gauge. As leases are typically set for a year and therefore enter the consumer price index with a lag, the strong increase in house prices in 2021 is arguably not yet fully reflected in inflation readings.

Meanwhile the UK will face continued supply impasses due to the ongoing Brexit process alongside the unfolding energy crisis. Although continental Europe is less at risk of a sustained uptick in prices given the larger output gaps and more sluggish demand impetus, the continent too will continue to feel the effects of elevated energy prices for the time being.

Across all developed economies, however, inflation rates are still likely to recede from current cycle heights in the course of 2022, as base effects in reopening inflation categories and energy prices subside or turn outright negative, and demand moderates from peak to above trend activity. The response of policy makers will be key in this regard. Most central banks have reassured investors that they will look through short-term moves in fuel and reopening prices given their volatile and transitory nature. This response will be adequate as long as inflation expectations remain contained, which is what current trading ranges within historic bandwidths imply. Should this pattern persist, policy makers need indeed not act preemptively.

Graph 5
Longer-term inflation expectations are still contained
(10-year break-even inflation rates across markets)

Source: Refinitiv, LGT Capital Partners

However, there is a non-trivial risk that inflation expectations - or inflation for that matter - will continue to rise because structural disinflationary forces are weakening. Most prominent in this regard are ongoing efforts to redirect and shorten value chains, promote economic regionalization, and boost the labor share of income via redistribution and reregulation. It is also noteworthy that the world will fail to see large one-off disinflationary boosts similar to the fall of the Iron Curtain, i.e. the end of Communism in Europe, or the reintegration of China into the global economy, over the next decade.

The big question therefore is what happens if inflation expectations increase further from here? Will policy makers put their foot down and hike rates aggressively? Cyclical and structural

[1] Unit labor costs have two inputs: wages and productivity. Because the latter is typically stable over a cycle, economist tend to focus on wages growth. However, this cycle could actually see an uptick in productivity due to the large-scale adoption of new technology. If so, unit labor costs (and thus the price level) should remain relatively unperturbed by rising wages.

considerations suggest they might rather err on the side of accommodation.

Erring on the side of accommodation

Firstly, unlike their predecessors in the 70s, the current generation of policy makers has been mired in a fight against deflation, not inflation. They are arguably more prone to letting inflation rise before feeling the need to act.

Secondly, the extensive involvement of fiscal spending in the pandemic policy response has forged and intensified links (both personal and institutional) between the various treasuries and central banks. Indeed, central bankers had for years asked for more fiscal spending instead of austerity – especially once the latter turned out to not be a politically viable solution in a low growth world. Both political and social considerations could thus coerce central bankers to "do their part" by keeping borrowing costs below nominal growth and inflation positive in order to accommodate the growing debt burdens and not endanger the recovery going forward.

Lastly, even without insinuating such a scenario of deliberate financial repression, new legal frameworks still compel policy makers to err on the side of accommodation. For example, legal changes to the Federal Reserve's mandate have sharpened its focus on inclusivity criteria, such as employment conditions across various ethnicities and wage sectors, resulting in the pursuit of maximum employment as well as the task to compensate for past inflation misses. Likewise, but to a lesser degree, the European Central Bank too can now let inflation overshoot – if deemed necessary. Whether the mandate is to target average inflation or to have a more symmetric focus on inflation does not matter at this stage. As both central banks have failed to engineer sufficiently high inflation rates for over a decade, they will now have to exceed the two percent anchor point to some degree and for an unspecified amount of time to showcase the credibility and necessity of their new frameworks. Until that credibility is established, inflation tolerance will hence remain skewed to the upside.

Hawkish central bank rhetoric?

Judged against this backdrop, the recent hawkish tilt in central bank rhetoric should not be overemphasized. In a world of zero interest rates and above trend growth, dialing back asset purchases is not a restrictive policy. Especially not when the pandemic is receding and the need for governments to issue additional bonds is faltering. If central banks reduce their bond purchases roughly in line with government bond issuance, market equilibria are unlikely to be shifted meaningfully. On the brighter side, however, the sails toward a gradual but actual tightening of monetary policy are increasingly being lifted, as first rate hikes in Norway and New Zealand suggest. And in view of the recent inflation dynamics, market participants have also started to price-in earlier and additional rate hikes in the UK and the US.

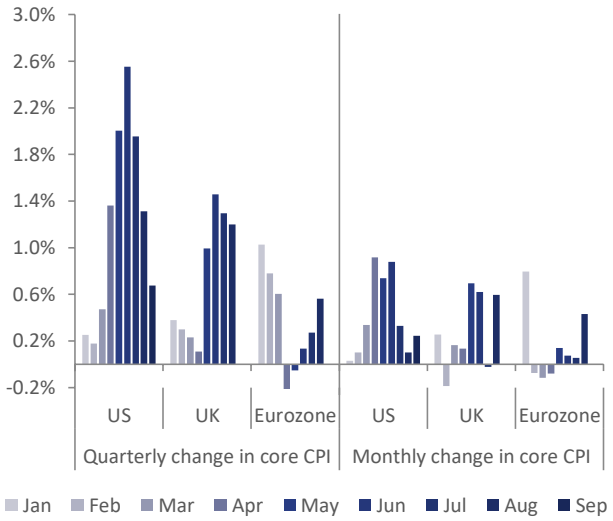
Our base case remains thus that inflation rates will likely stay elevated in 2022 but that price pressures are ultimately contained. They will most likely not continue to print mid-single digit figures thanks to moderating demand, fading base effects and possibly rising productivity due to the pandemic-imposed broad-based technology adoption, as well as other reasons outlined before. But in a world of continuing supply impasses and structurally abating disinflationary forces, they are just as unlikely to fall below central bank targets.

To get a hunch on where inflation is effectively headed given the strong base effects and ongoing data distortions, we recommend that investors closely monitor monthly and quarterly changes in consumer prices alongside the more commonly watched annual changes in inflation. Currently, these readings continue to support the notion of a slowdown in price increases. If this pattern persists, inflation will ultimately be contained. Conversely, evidence to the contrary could eventually toll the bell for the transitory inflation narrative.

Graph 6

Quarterly and monthly inflation remain hump-like

(Quarterly and monthly changes in core inflation)



Source: Refinitiv, LGT Capital Partners

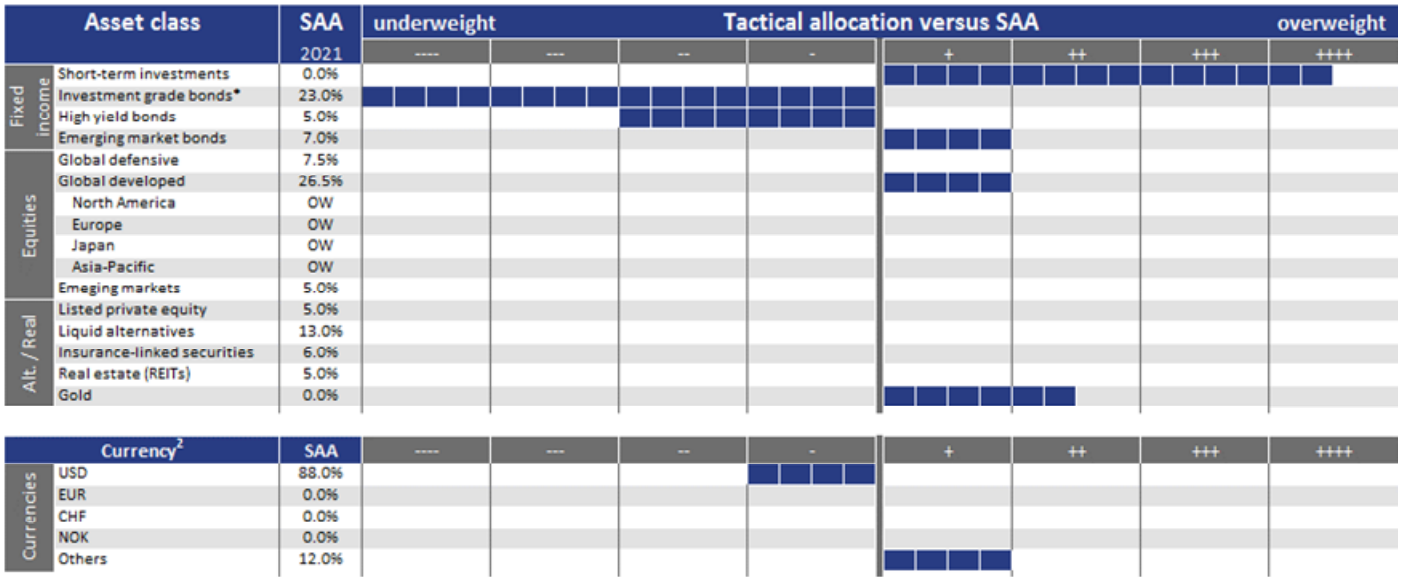
Regardless of the outcome, investors should continue to expect higher inflation uncertainty and an upside skew in prices relative to the past cycle, as the global economy progresses on its turbocharged but volatile post-pandemic trajectory, and both cyclical and structural factors promote relatively loose monetary conditions for the foreseeable future.

END OF REPORT

LGT Capital Partners: tactical asset allocation

The tactical asset allocation (TAA) is set quarterly with a time horizon of up to six months. The table shows our current positioning versus the strategic allocation (SAA) of the LGT Endowment, or Princely Strategy, for 2021.

- **Equities: modest tactical overweight in developed markets, with an emphasis on reflationary/reopening themes**
- **Fixed income: underweight, with a preference for emerging markets bonds issued in local currencies**
- **Alternatives and currencies: moderate position in gold combined with a passive overweight in EM currencies**



Reference portfolio: LGT GIM Balanced (USD). The TAA is valid for all similar portfolios but various restrictions or liquidity considerations can lead to deviations in implementation. In currencies, "others" represents indirect exposures resulting from unhedged positions in markets against the base currency. * Includes global government, inflation-linked and corporate bonds.

Performance of relevant markets

		1 month	3 months	Year to date	3 years, p.a.[1]	5 years, p.a.[1]
Fixed Income						
Global government bonds	USD	-1.2%	-1.7%	-2.8%	4.6%	2.6%
Global inflation linked bonds	USD	0.0%	1.4%	4.3%	4.7%	3.4%
Investment grade corporate bonds	USD	-1.1%	-1.2%	-1.0%	5.8%	3.6%
High yield bonds	USD	-0.9%	-0.4%	1.7%	6.6%	5.9%
Emerging markets [2]	USD	-2.0%	-1.7%	-3.9%	4.9%	3.1%
Equities						
Global	USD	3.2%	4.8%	19.6%	16.6%	14.7%
Global defensive	USD	0.0%	0.9%	9.4%	9.8%	9.7%
North America	USD	4.0%	5.0%	21.1%	19.9%	17.8%
Europe	EUR	2.9%	4.4%	18.0%	10.3%	8.4%
Japan	JPY	-2.7%	8.2%	14.4%	9.4%	10.7%
Emerging markets	USD	3.1%	-0.7%	2.1%	12.6%	9.7%
Alternative and real assets						
Listed private equity	USD	5.2%	12.0%	47.2%	27.0%	21.5%
Hedge funds	USD	0.1%	-0.2%	6.6%	5.6%	4.8%
Insurance linked securities (ILS)	USD	1.8%	1.6%	4.1%	4.3%	3.6%
Real estate investment trusts (REITs)	USD	0.3%	0.3%	23.4%	13.1%	8.6%
Gold	USD	0.7%	-1.9%	-6.4%	13.1%	7.0%
Currencies (vs. rest of G10) [3]						
US dollar	USD	-1.2%	-1.3%	2.2%	-1.2%	-0.6%
Euro	EUR	-2.0%	-2.6%	-3.1%	-0.8%	0.8%
Swiss franc	CHF	-0.7%	-1.6%	-2.5%	1.6%	1.0%
Japanese yen	JPY	-6.0%	-5.7%	-8.9%	-1.8%	-2.7%
Australian dollar	AUD	2.4%	1.1%	-0.8%	0.7%	-1.0%
Norwegian krone	NOK	3.7%	7.3%	5.2%	-1.8%	-1.0%
British pound	GBP	-0.2%	0.0%	3.2%	0.8%	2.1%
Canadian dollar	CAD	3.0%	1.6%	5.7%	1.0%	1.0%
Chinese yuan (vs. USD)	CNY	0.7%	1.2%	1.8%	2.6%	1.0%

[1] Annualized return [2] Equal-weighted hard and local currency total return indices [3] Bloomberg correlation-weighted currency indices of a currency versus its nine major counterparts, except for the CNY (shown against the USD).| Source: Bloomberg

Economic and corporate fundamentals

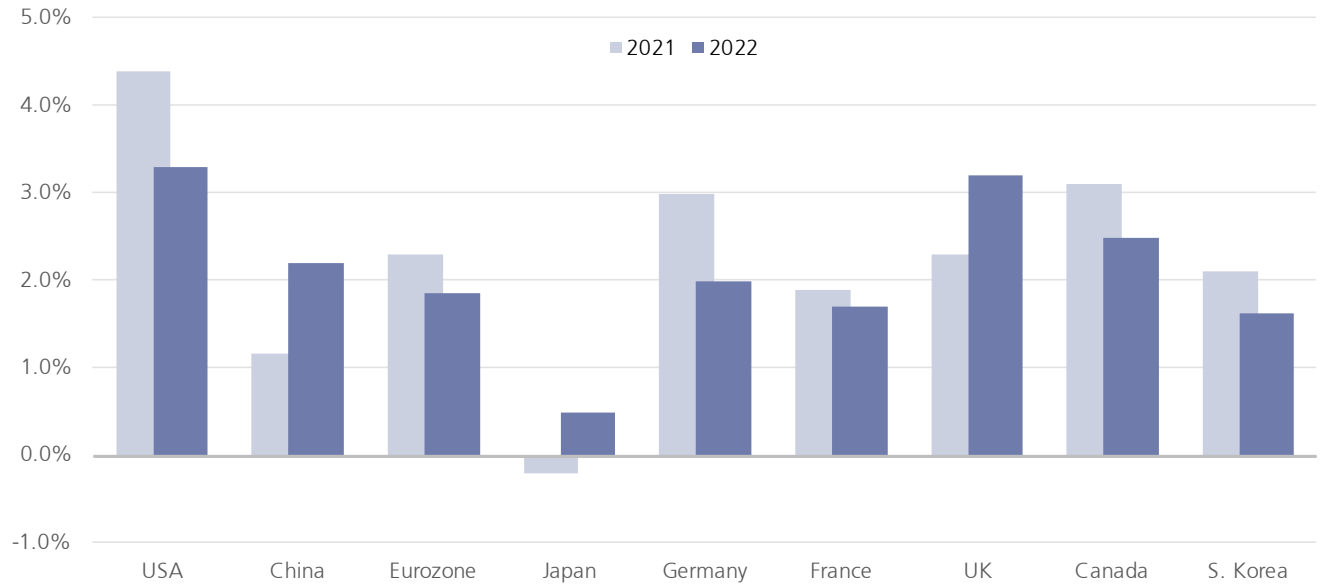
		USA	China	Eurozone	Japan	Germany	France	UK	Canada	S. Korea
Gross domestic product (GDP)										
Nominal, this year[1]	bn USD	22'675	16'642	14'518	5'378	4'319	2'938	3'125	1'883	1'807
Per Capita, purchasing power parity[1]	USD, PPP	68'309	18'931	40'965	44'585	56'956	49'492	47'089	51'713	47'027
Real growth this year[1]	Consensus	5.8%	8.2%	5.0%	2.4%	2.9%	6.1%	7.0%	5.0%	4.0%
Real growth next year[1]	Consensus	4.0%	5.5%	4.3%	2.5%	4.3%	4.1%	5.1%	4.0%	3.0%
Real growth current quarter	Annualized	6.7%	0.8%	8.7%	1.9%	1.6%	1.1%	5.5%	-1.1%	0.8%
Unemployment this year	Consensus	5.5%	3.9%	7.9%	2.9%	5.7%	8.0%	4.8%	7.6%	3.9%
Inflation this year	Consensus	4.4%	1.2%	2.3%	-0.2%	3.0%	1.9%	2.3%	3.1%	2.1%
Inflation next year	Consensus	3.3%	2.2%	1.9%	0.5%	2.0%	1.7%	3.2%	2.5%	1.6%
Purchasing manager index (comp.) [2]	Neutral: 50	55	51	56	48	56	55	57	57	52
Structural budget balance/GDP	IMF	-12.9%	-9.0%	-5.9%	-8.5%	-4.0%	-5.2%	-5.0%	-6.7%	-2.4%
Gross government debt/GDP	IMF	132.8%	69.6%	98.9%	256.5%	70.3%	115.2%	107.1%	116.3%	53.2%
Current account balance/GDP	IMF	-3.9%	1.6%	2.6%	3.6%	7.6%	-2.1%	-3.9%	-0.8%	4.2%
International currency reserves	bn USD	41.8	3'200.6	566.6	1'284.9	37.5	54.0	127.9	78.0	439.3
Govt bond yield 2yr [3]	% p.a.	0.40%	2.54%	-0.52%	-0.10%	-0.63%	-0.66%	0.73%	0.83%	1.81%
Govt bond yield 10yr [3]	% p.a.	1.65%	3.00%	0.14%	0.10%	-0.10%	0.24%	1.17%	1.62%	2.40%
Main policy interest rate ?	% p.a.	0.25%	4.35%	0.00%	-0.10%	0.00%	0.00%	0.10%	0.25%	0.75%

[1] IMF estimates [2] Manufacturing PMI for Korea [3] Currency swap rates for China and Brazil and closest ESM/EFSF bond for Eurozone ? Max target rate for Fed

		USA	Eurozone	China	Japan	Germany	France	UK	Canada	S. Korea
Exchange capitalization*	bn USD	51'825	10'117	18'726	6'819	2'751	862	3'692	895	2'216
Growth in earnings per share, estimated (MSCI)										
12 months forward / trailing 12 months	Consensus	27.0%	35.5%	22.1%	13.6%	36.1%	47.6%	57.4%	19.8%	45.0%
Next fy / 12m fwd	Consensus	2.8%	2.0%	3.3%	3.7%	2.7%	1.9%	0.5%	1.5%	-0.3%
Growth in revenue per share, estimated (MSCI)										
12m fwd / trail 12m	Consensus	12.0%	5.3%	23.8%	9.4%	8.2%	8.1%	10.2%	4.7%	7.9%
Next fy / 12m fwd	Consensus	1.9%	1.1%	2.6%	1.6%	1.2%	1.2%	0.8%	0.9%	1.4%
Valuations (MSCI)										
Price-Earnings Ratio (est 12m fwd)	Consensus	21.6	15.6	13.7	14.8	13.8	15.9	12.2	15.5	10.4
Price-Sales Ratio (est 12m fwd)	Consensus	2.9	1.3	1.4	1.1	1.0	1.4	1.3	2.2	0.9
Dividend yield	Consensus	1.3%	2.8%	1.8%	2.2%	2.8%	2.8%	4.2%	2.5%	1.8%

* China market cap includes Hong Kong | Source: Bloomberg Data per: 20.10.2021

Expected annual inflation rates



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