Quarterly Investment Outlook

3rd Quarter 2021 June 2021

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Advisor's Commentary

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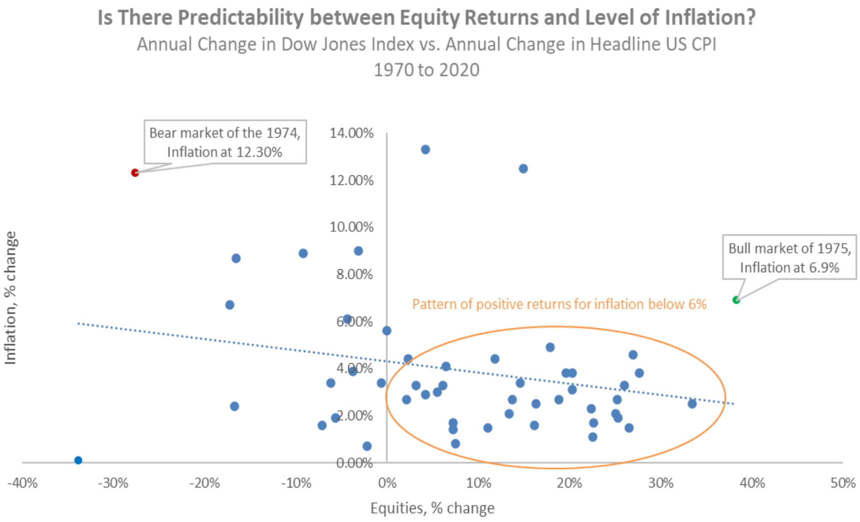
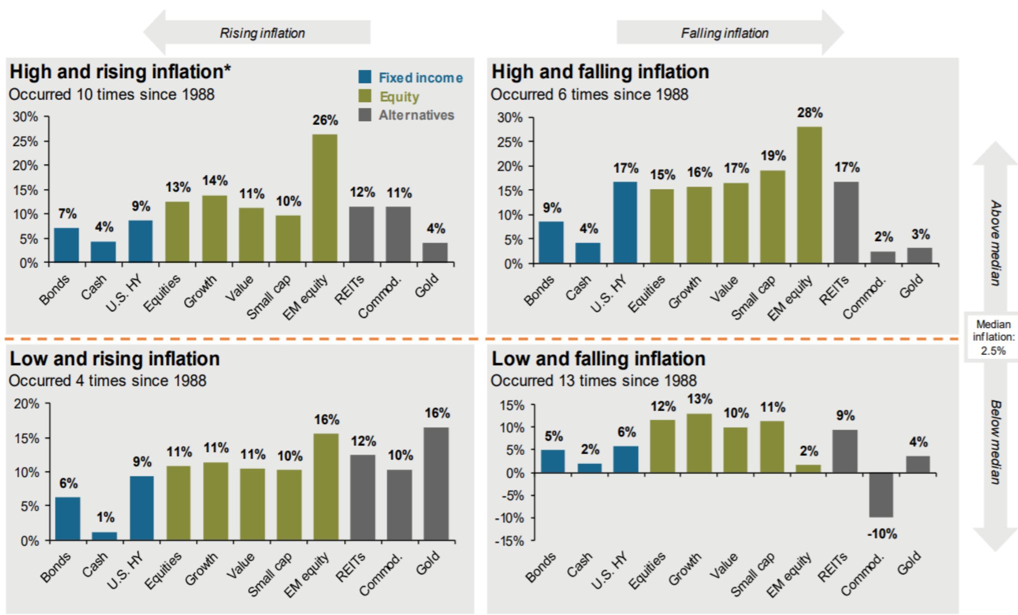
Now that inflation is edging up, the lingering question is whether it will be transitory. The most probable answer is: who knows? Central bankers' confidence in that price pressures are temporary is somewhat puzzling considering their track record of predicting spillover effects. In 2007, the sitting US central bank chief said the housing crisis was confined to the subprime mortgage market and unlikely to hurt the overall economy. By 2008 the world was facing the worst financial crisis since the Depression. Predictive powers aside, perhaps more interesting is the relationship between inflation and capital returns. Inflation, as the current narrative goes, will erode asset values as it leaps higher. Yet the relationship is more spurious than that. Using the equity market as a proxy for risky assets and going back as far as inflation data allows for, about 50 years, our observations reveal little predictability between the two variables. During extreme inflationary environments, for instance in the mid-seventies, where inflation was double digits, equity returns were both deeply negative *and* highly positive like in 1974 and 1975, respectively. In fact, multiple occurrences show both negative *and* positive equity returns at elevated inflation levels. Interestingly, the sample study does imply that for inflation rates below 6% equity returns tend to be positive.



Source: Bloomberg LP, Ameliora Wealth Management AG

[1]Dow Jones Industrial Average is used as a proxy for risk capital due to extensive historical data series. Inflation data, represented by United States Consumer Price Index Urban Consumers Non Seasonal Adjusted, annual percentage change, is also used due extensive historical data series.



Source: J.P. Morgan Asset Management. *High or low inflation distinction is relative to median CPI-U inflation for the period 1988 to 2020 (33 years), which was 2.5% y/y. Rising or falling inflation distinction is relative to previous year CPI-U inflation rate. Indices: Bonds – Bloomberg Barclays U.S. Aggregate; Cash – Bloomberg Barclays 1-3 Month T-Bill index since its inception in 1992 and 3-month T-Bill rates prior to that; U.S. high yield – Bloomberg Barclays US Aggregate Credit (corporate high yield); Equities – S&P 500; Value – Russell 1000 Value; Growth – Russell 1000 Growth; Small Cap – Russell 2000; EM equity – MSCI Emerging Markets (USD); REITs – FTSE NAREIT/ All Equity REITs; Commodities – Bloomberg Commodity Index since its inception in 1992 and S&P GSCI prior to that; Gold – NYM $/ozt continuous future closing price. For illustrative purposes only. Past performance is not indicative of comparable future returns. Returns are based on calendar year performance and are total return unless otherwise specified.

Central bankers argue that because of "base" effects, higher inflation is likely temporary since the measured level is coming off a low base number. Therefore, any percentage change will look lofty. There is some merit in that, but ruling out inflation staying elevated for longer seems somewhat credulous. After all, the risk is that inflation will depress asset values, and being dismissive of such outcomes, especially in times of elevated asset pricing seem irresponsible. Perhaps central bankers' confidence stem from previous observations of inflation and asset price returns. Findings from J.P. Morgan, spanning over 30 years, do actually show few adverse effects on asset returns during inflationary environments, regardless of whether starting from a low or high base. The riskiest assets, such as equities, have according to the investment manager held up quite well in either of these environments. One could take some solace in these past patterns, but history has also shown that loose monetary policies, ballooning deficits, and soaring commodity prices (just like today as in the 70s), inflation can spiral uncontrollably and stay elevated for a lot longer than any central banker's comfort zone.

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