Incrementum Inflation Signal Indicates a Weakening of Inflation Momentum: A New Conundrum?

Dear investors, advisory board members and friends,

We're writing to inform you, that as of mid-July, **our proprietary inflation indicator has decreased from "100% RISING INFLATION" to "50% RISING INFLATION", and thus reached its lowest level in more than a year.**

What's New?

Gold and other inflation-sensitive assets are currently facing competing pressures from a strongly inflationary environment on the one hand and an increasingly hawkish outlook for US monetary policy on the other. The result has been an extended phase of price consolidation for inflation-sensitive assets, with short-term ups and downs in price being driven by the news cycle. In June, the Federal Reserve hinted via the infamous "dot plots" that the first interest rate hike could happen slightly earlier than expected. This lead to a significant drop in precious metals and mining stocks. Meanwhile, the outcome of the latest OPEC+ meetings has put downward pressure on oil prices. OPEC+ members agreed to increase oil production and fully end production cuts by September 2022. **But what does all of this mean for the financial markets? Let us explain our view and provide a brief outlook.**

A New Conundrum?

It was back in 2005 when the **divergence of short-term interest rates and long-term Treasury yields** left the markets in astonishment and confusion. Short-term interest rates rose, but – despite a booming economy and increasing inflation momentum – longer-term U.S. Treasury yields remained fairly stable. Fed Chair Alan Greenspan famously described this situation as a "*great conundrum*".

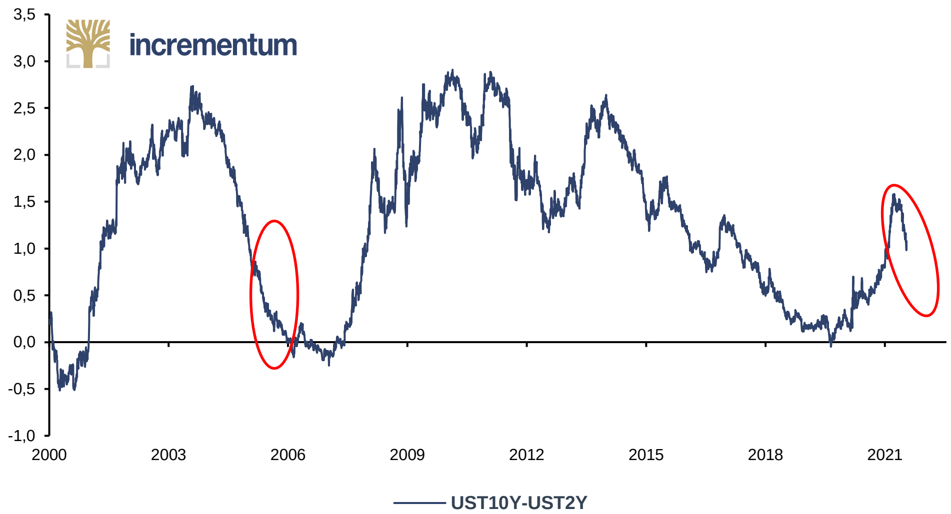
UST10Y, and UST2Y, in %, 01/2000-07/2021

Source: Reuters Eikon, Incrementum AG

The market movements of the past few weeks suggest that a similar conundrum is manifesting itself today. Of course, what is different today compared with 2005 is that hawkish policies have yet to be put into effect. However, the announcements and expectations of (sligthly) tighter monetary policy, especially in the case that inflation pressures persist, should – at least according to economic theory – affect longer-term bond yields.

According to the popular narrative, the US economy is in the process of making a relatively strong post-pandemic recovery. The current stagnation or even fall in U.S. bond yields gives us reason to search for the **solution to the new conundrum.**

UST10Y-UST2Y, 01/2000-07/2021

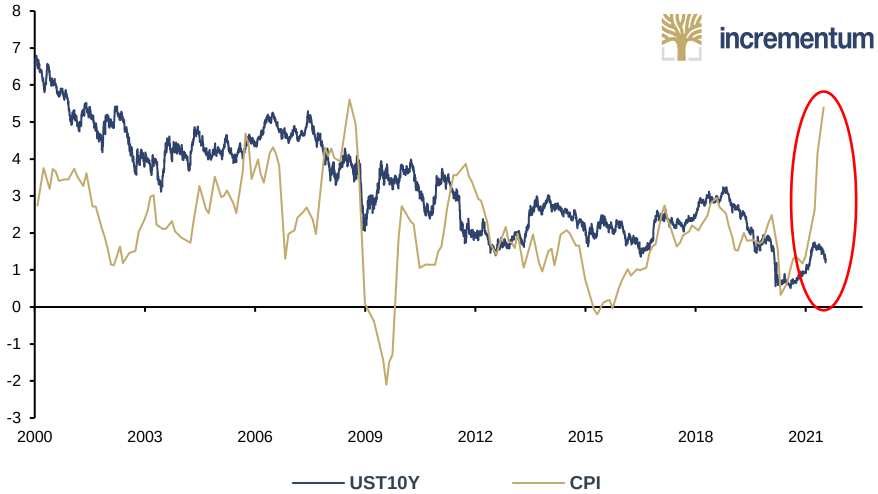


Source: Reuters Eikon, Incrementum AG

Solving the Puzzle

The chart below portrays the heart of the conundrum. We observe a counterintuitive reaction from the U.S. 10-year bond yields to the tremendous spike in CPI inflation. Instead of moving in the same direction as CPI, bond yields have continued their long-term downwards path. What possible explanations are there for this market behavior?

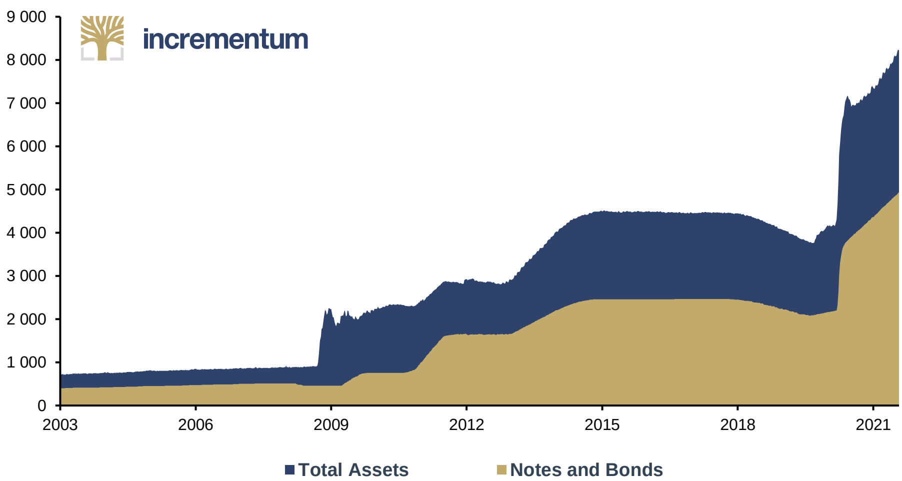
UST10Y, in %, and CPI, yoy%, 01/2000-07/2021



Source: Reuters Eikon, Incrementum AG

The factor that comes to mind first is the asset purchasing programs of the Fed. The Fed is currently buying USD 80 bn of Treasury bonds every month, which has a huge distortionary impact on markets. However, these purchases have been going on for over a year and we should therefore not affect prices "*at the margin*".

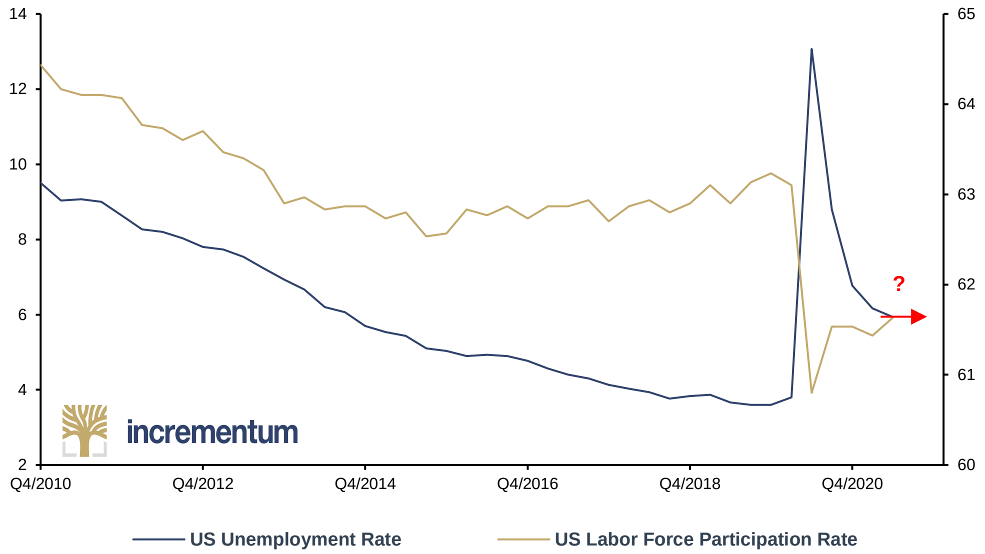
Fed Balance Sheet, in USD bn, 01/2003-07/2021



Source: Federal Reserve St. Louis, Incrementum AG

In our view, a potential reason for the strong bond market is a slower than expected GDP growth resulting from the decreasing momentum of the reopening boom and the growing threat posed by the more contagious delta variant of the coronavirus. **Bond markets seem to have become quite pessimistic about the overall economic situation.**

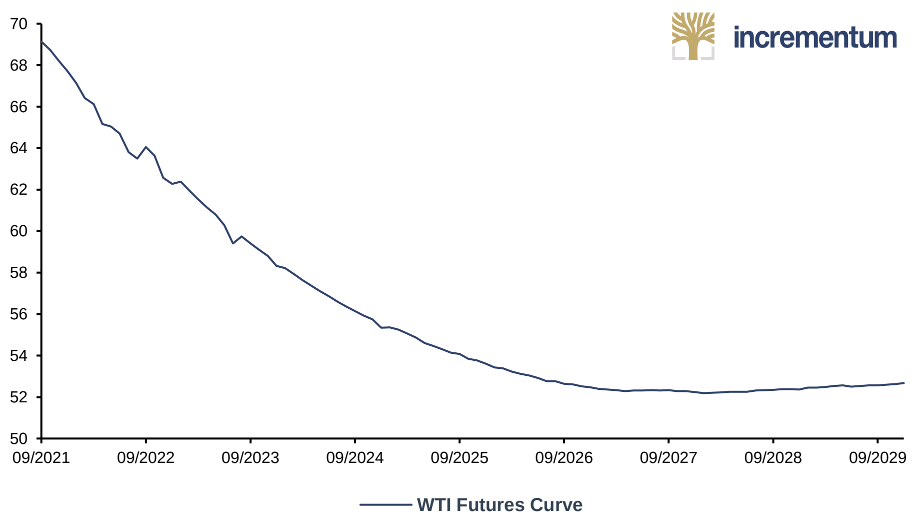
US Unemployment Rate (lhs), in %, and Labor Force Participation Rate (rhs), in %, Q4/2010-Q2/2021



Source: Reuters Eikon, Incrementum AG

Inflation expectations provide another explanation for low bond yields. Most analysts expect inflation to be *transitory*, and therefore expect no significant rate hikes. One indication of this thesis can be found in the futures curve of oil prices, which demonstrates that the market expects oil prices to fall.

WTI Futures Curve, 09/2021-12/2029



Source: Reuters Eikon (as of August 4th 2021), Incrementum AG

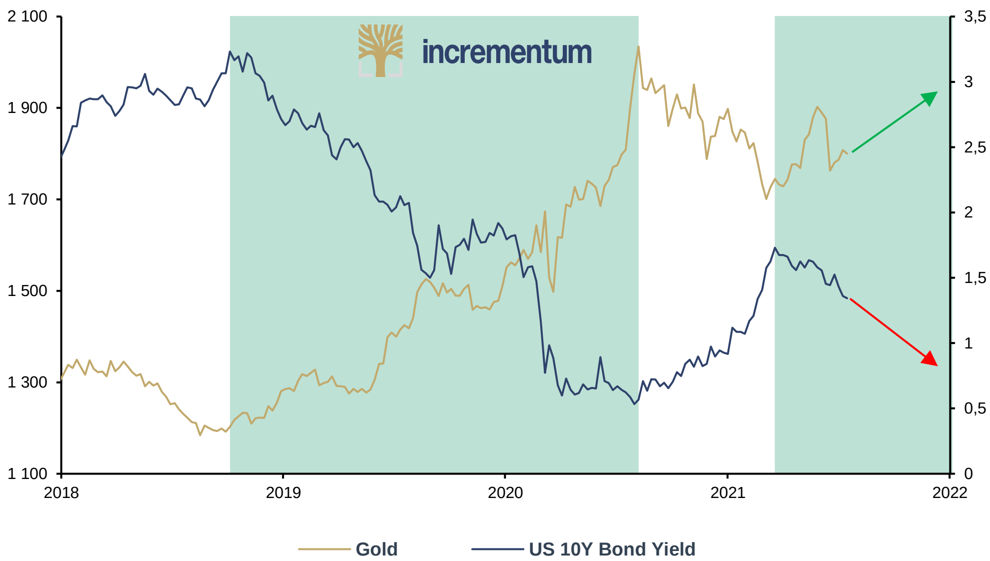
This expectation of transitory inflation would also explain the lackluster price action of gold, despite the fact that real interest rates went into even more negative territory. Nevertheless, it is hard to tell what the driving forces are behind the disconnection between Treasury yields and (expected) interest rates. Factors other than those mentioned above cannot be ruled out, and the new conundrum may prevail for some time.

Our position on the current macroeconomic development is crystal clear: **We see the inflation pattern as non-transitory**. The declining momentum of the US economy could be the start of a stagflationary environment that the market is not yet fully grasping. Even if, in the short term, the inflation momentum subsides somewhat – something that is also being signaled by our proprietary Incrementum Inflation Signal – we think inflation momentum will pick up quite rapidly once the next round of stimulus starts to be discussed.

Implications for Gold

We now turn to the potential impacts of the new conundrum on gold. History and economic theory suggest that a fall in longer-term bond yields – like the one we are seeing now – will have a positive impact on gold, as the opportunity costs of holding it fall. In the chart below, we can see that in the recent period of falling U.S. 10-year bond yields (shaded in green), the gold price has exhibited a significant upward trend. If market participants do not change their expectations, gold will most probably end up as a beneficiary of the interest rate conundrum.

Gold (lhs), in USD, and US 10Y Bond Yield (rhs), in %, 01/2018-07/2021

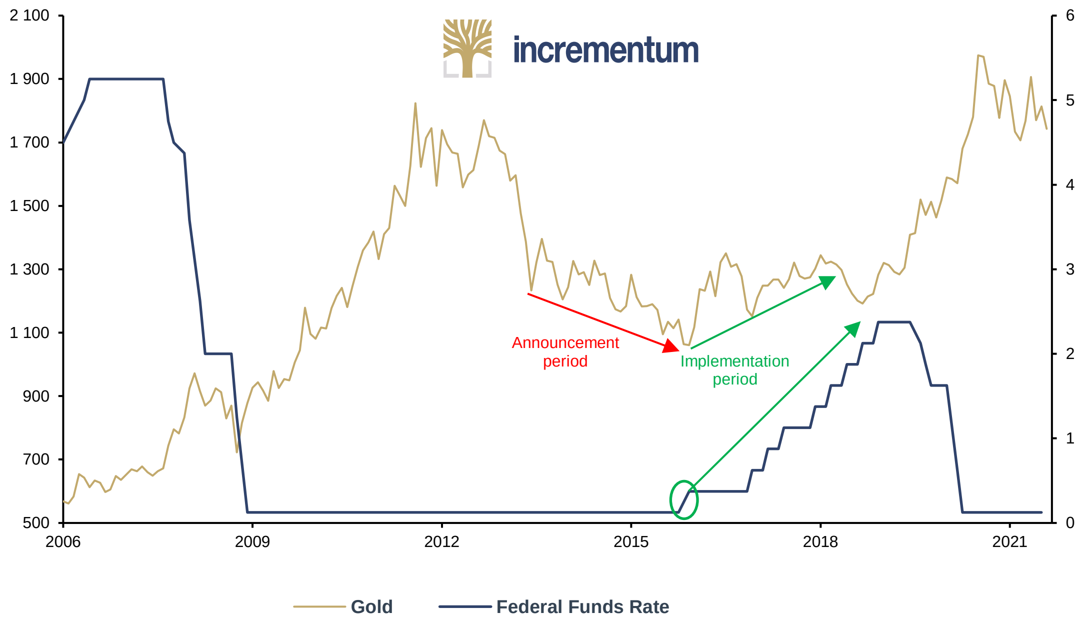


Source: Reuters Eikon, Incrementum AG

If expectations do change, and the Fed gains credence in their monetary policy outlook, it would mean that markets will react appropriately to the communication of policymakers, resulting in a restrictive response. However, this scenario is not necessarily negative for the gold price, although it would most likely imply a rise in bond yields. This is the case because it would mean that inflation expectations have changed among market participants - away from a transitory to a more long-lasting inflationary environment. Therefore, **we view gold as one of the winners regardless of which of these two scenarios occurs**.

Gold investors should not have to be afraid too much of further downside movements of their favourite precious metal. Considering markets are trading expectations, there are good reasons to believe that the market has already soaked up the expectations of interest rate hikes and tapering of asset purchases. The actual implementations of monetary policy measures typically do not affect prices of any assets and commodities. Policy makers are increasingly making use of their forward guidance ability. Not unfounded, as it is a powerful tool to control and navigate the market, especially in turbulent phases. In the past, we have seen that gold even performed well at interest rate hike periods.

Gold (lhs), in USD, and Federal Funds Rate (rhs), in %, 01/2006-08/2021



Source: Reuters Eikon, Incrementum AG

This can be explained by the forward guidance made by policy makers at the FOMC meetings, where they regularly presented a rather dovish outlook right after agreed interest rate hikes. This means that currently, **we might see the ultimate downside of gold and silver in the present macroeconomic environment as market participants have already traded their expectations**.

Investment Impact

In response to the observed change in our proprietary inflation indicator, signaling a consolidation of inflation momentum, we have reduced our commodity positions and completely closed our positions in commodity currencies (esp. AUD/USD, CAD/USD). On the precious metals side, we have reduced our silver exposure and kept our total gold exposure. Moreover, we have put in "stink bids" for some of the quality names in the gold and silver mining space. We also pursued our deflation strategy by opening short positions on the Russell 2000 and Nasdaq 100. A cooldown of the reopening boost and rising uncertainty concerning the economic policy outlook could very likely lead to a correction in the overheated equity markets. We are convinced that our exposure adaptions make us well-positioned to deal with the current economic environment.

We believe that the current volatility in inflation-sensitive assets represents a tremendous buying opportunity— and we are keen to utilize it. We remain cautious regarding the commodity sector in general for the time being. Our gut feeling is that this move will turn out to be a short consolidation and that the inflation trade will pick up sooner rather than later.

We are here for you and would be happy to take the time to talk to you about your investments. Do not hesitate to call or write to us if you have any questions or suggestions.

Best regards and, above all, good health to you and your loved ones!

Sincerely,

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