BFI Infinity InSights | May 2021

CEO Corner

Spring arrives for the global economy

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Since the release of our January InSights update, the global economy has continued to go through a challenging time. But now, finally, the outlook is turning more positive for the future, as the world is starting to get the pandemic under control. While more and more people, especially in the West, are vaccinated, there are still regions where the pandemic is still raging, which is especially true for India. And yet, despite this, global macro-economic indicators are pointing to a solid global recovery that will, in combination with massive fiscal stimulus programs, lead to a very strong bounce for the world economy.

The concern now is whether this recovery might prove to be too strong. Especially in the U.S., there are legitimate fears over "overheating" the economy. The new administration under President Biden has launched an economic stimulus program that is larger than anything we have ever seen before. The question is how much this will push up inflation and how much are yields going to rise in the months and years ahead. Indeed, after the historically high government debt levels around the world, higher interest rates might be the second biggest risk for the global financial system.

Back in January, our outlook was cautiously optimistic for financial markets for the remainder of 2021, but we also pointed out that due to rising yields, there could be an uptick in market volatility during the first quarter. Indeed, as we anticipated, during February and March we saw pressure on equity prices worldwide, as investors became concerned over higher rates and tried to digest the new reality. At BFI Infinity, we kept our portfolio hedges in place and that certainly helped a lot to keep the value of our client portfolios stable during this more volatile period.

With the start of April and the arrival of spring, we have also seen renewed confidence and optimism in global equity markets, that started to perform strongly and now seem to be less sensitive to the possibility of rising yields and inflation. Equity prices rose during the month of April, with the commodity sector showing a particularly strong performance. As we have already mentioned a few times in our analyses, it is our belief that commodity prices are at the start of a multi-year bull market. This is why we already began investing in commodities for our clients last year and have since then increased our exposure.

While we are almost fully invested in equities, we are of the opinion that, for the time being, long positions in stocks should be hedged with put options, as the probability of a bigger correction is still considerable in the current environment. However, what gives us a lot of hope is the fact that the strength of the recovery has increased quite substantially. In 2020, equity markets were largely driven by two sectors, technology and healthcare, whereas the momentum now has spread into a broad range of other industries. This more broad-based move in the market is usually a very healthy sign for a bull market and we therefore think there is more upside to come as the recovery progresses.

Also interesting in this context is the fact that European markets have outperformed the U.S., as well as Asia, in the first couple of months of 2021. It is still too early to tell, but after several years of outperforming US markets, we could now be at a turning point. Normally, when either European or U.S. markets outperform, these trends tend to remain in place over longer periods of time. So this might be good news for European equities, especially considering the fact that they are significantly cheaper in terms of valuation.

At this point, we'd also like to highlight two especially important themes too, one concerning the US Dollar and the other the outlook for precious metals, particularly gold. The Dollar has been showing some weakness over the past few weeks, after a relatively strong performance the better part of 2020. We believe this downtrend will likely continue in the coming months and years. In fact, we expect the decline to persist for at least another 3 years and possibly even hit a new all-time low.

This renewed weakness in the Dollar is also starting to have an effect on precious metals prices. Gold was consolidating since last year when it reached a new all-time high, but then, in early March and early April, it tested the lower support level of around USD 1685 twice and successfully bounced back from it. So-called "double bottom" formations like this often indicate that there is a trend reversal taking place and indeed, after testing the USD 1685 level for the second time, the price of gold moved up quite decisively and surpassed the USD 1800 level in recent days. At the moment, it would still be premature to form a firm conclusion, but it certainly looks like gold and silver might be headed higher from here.

All the points we have discussed here, an improving macroeconomic environment, international equity markets that have started to build momentum, a declining U.S. Dollar and positive signs for precious metals, are factors that speak for a globally diversified investment portfolio. With this overall pretty positive outlook, we hope that the summer will bring us a renewed sense of optimism and a long awaited return to normality in our lives, as the pressures and the challenges that the pandemic brought finally start to lift.

Feel free to contact us directly at info@bfiwealth.com, with any questions. We look forward to hearing from you.

Bonds: From risk-free returns to return-free risk?

Dirk Steinhoff
Chief Investment Officer

When looking to add a low-risk component to an investment strategy, investors typically think of bonds. These fixed income instruments have delivered an outstanding and very reliable performance over the last 40 years, thanks to the continuous trend of falling interest rates, and to this day, they are commonly perceived as a safe investment. However, a lot has changed over the last year and many core assumptions have been overturned. In the aftermath of the covid crisis, the climbing inflation expectations, the unprecedented stimulus operations and the record levels of public debt, does the investment case for bonds still stand?

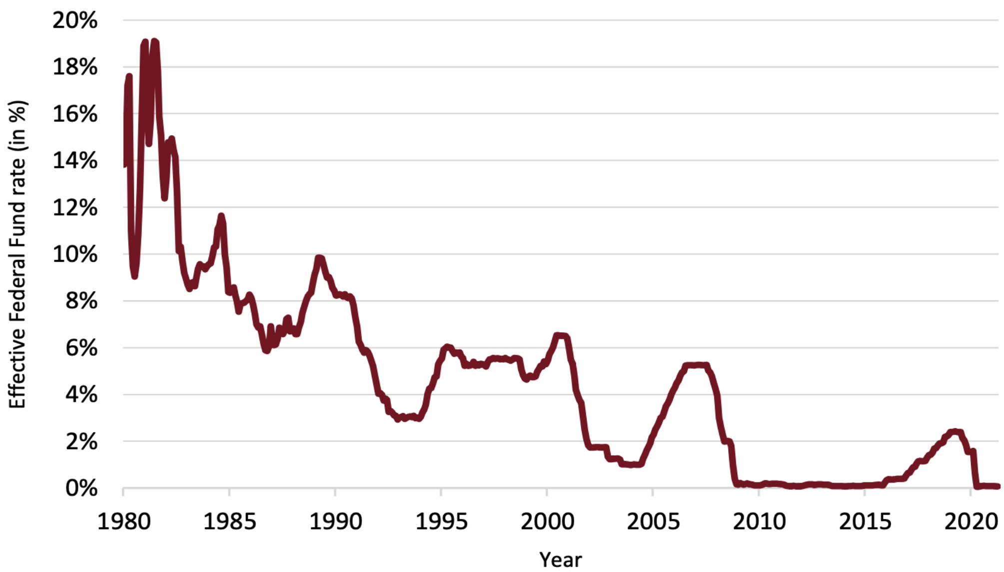
Interest rates at a turning point

Bond prices are inversely related to interest rates, meaning they fall when interest rates rise, and vice versa. When interest rates fall, newly issued bonds will have a lower interest rate compared to those issued in the past, which increases the demand for the existing bonds and pushes prices higher. This is precisely the scenario we have experienced over the past 40 years in the U.S. and the main reason why bonds came to be viewed as low-risk, reliable investments.

There is, however, another scenario too: Rising rates. When interest rates rise, investors flock to the newly issued bonds, that offer better rates, causing the older bonds to lose value. This might seem obvious, but the important thing to note here is that this loss in value can occur very quickly and it can be quite substantial, as illustrated in Figure 2. For instance, a mere 2% increase in the interest rate leads, on average, to a loss in value of almost 10% for a 5-year bond. In the case of a 30-year bond, almost half of its value is wiped out, due to that seemingly small interest rate increase.

Overall, the ultimate impact of an interest rate increase on a bond depends on the magnitude, the speed and the persistence of that increase. If it's only a small change that is perceived as exceptional and likely to be short-lived, many investors hold on to

Figure 1: Development of US effective Federal Funds rate, 1980 – 2021



Source: Federal Reserve of St. Louis

their bonds, thereby limiting the losses. Contrariwise, in the case of a rapid and substantial interest rate increase that is expected to persist, bondholders rush to sell their positions and the price decline of bonds is much more severe, in particular for bonds with a long maturity (see Figure 2). If these bonds also serve as collateral for a loan, such an increase can lead to margin calls and forced sell-offs. The risk of a banking crisis related to the huge derivatives market, where most instruments are tied to interest rates, is even larger.

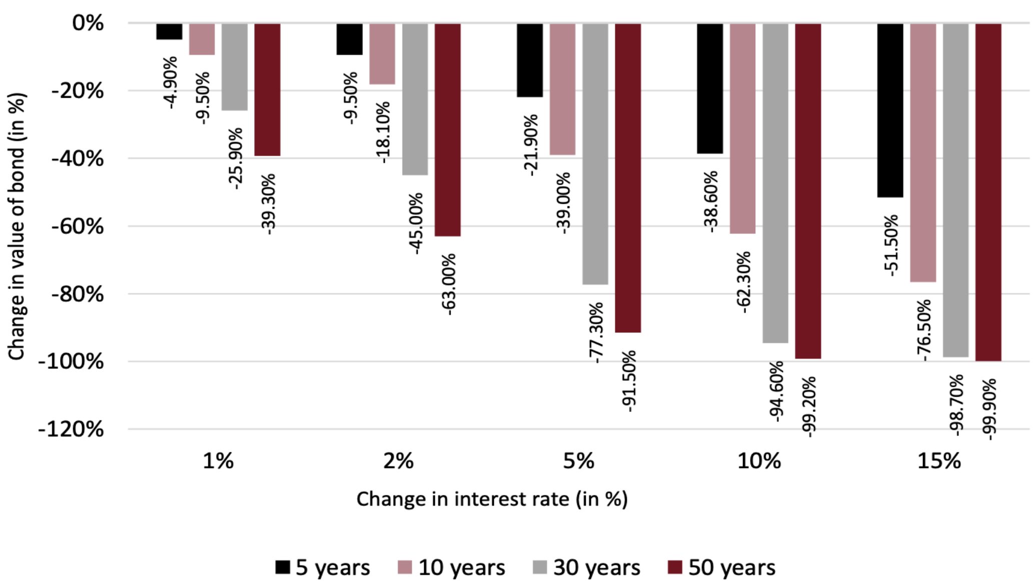
For some, this might seem like a far-fetched scenario, given the fact that for the last 40 years, we have seen interest rates more or less continuously decline. Especially over the last decade, consistent and massive interventions by the Federal Reserve successfully kept interest rates extremely low, even during turbulent periods and even when it was thought that an increase was inevitable. The central bank's resolute stance and its firm commitment to its interest rate policy bolstered investor confidence throughout the covid crisis as well and it created the impression that interest rates could be kept low forever.

And yet, we feel that the extraordinary developments we saw over the past year and the inflationary pressures that built up are too powerful to ignore. We have very likely reached a crucial turning point and the era of ultra-low interest rates may be about to come to a close.

Among the clearest indications that we are likely headed in that direction are the unprecedented debt levels and the almost exponential increase in the money supply. Of course, public debt in the U.S. has been climbing over the past 40 years (see Figure 3). It is therefore far from a new problem, however, what is different this time, is its record acceleration. In addition, the covid crisis saw the Fed balance sheet being inflated even more in an effort to stimulate the economy and avoid a recession, but with interest rates at a record low, monetary stimulus is no longer an effective instrument, creating an even higher demand for fiscal support. The combination of massive monetary and fiscal stimulus has created enormous liquidity flooding the markets, an inflationary force which can, at some point, only be dampened by higher interest rates.

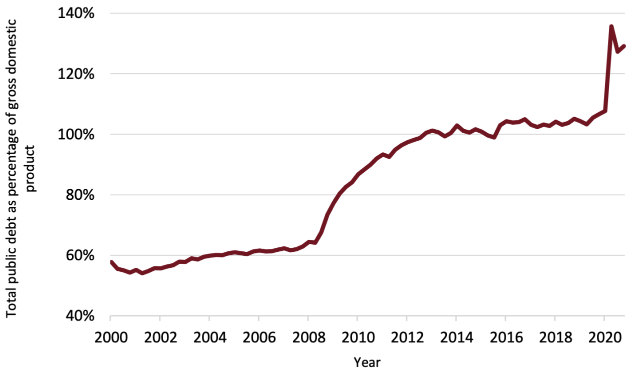
Another important factor that is set to contribute to higher interest rates is the deglobalization trend. Since the 90s, we have witnessed the emergence and establishment of international value chains and increased trade across the globe, that pushed production prices down and created seemingly endless

Figure 2: Impact of interest rate increases on bond value



Source: Kopernik (2020), Bloomberg data

Figure 3: US public debt as a percentage of GDP, 2000-2020



Source: Federal Reserve of St. Louis

supply capacities. Thanks to these disinflationary forces, the Fed was relieved of the burden of having to increase interest rates, something it usually does when it wants to avoid an overheating of the economy. However, we are now seeing signs of this trend slowing down, or arguably even reversing. The ongoing impact of the pandemic on global supply chains and the U.S.-China trade tensions are just two among many deglobalizing forces. Should this trend continue or intensify further, it could put pressure on the U.S. central bank to proceed with interest rate hikes in order to keep inflation in check.

Given the scale and the importance of these shifts in the global economic landscape, we believe that the risks of climbing inflation and higher interest rates should be taken seriously by investors and especially by bondholders. Clearly, we don't expect this sea change to happen overnight. After four decades of declining interest rates, such a reversal will take time and will be accompanied by significant volatility, but even so, this outlook considerably weakens the investment case for bonds and presents a very unattractive risk-return ratio.

What about TIPS and floaters?

With the investment appeal of bonds being significantly dampened, many investors look for alternative fixed income instruments, the most popular of which being Treasury inflation protected securities (TIPS) and floating rate notes (FRN).

A TIPS is a security issued by the U.S. government and the idea behind it is to protect investors from declining purchasing power. This is achieved by paying a fixed interest rate on a principal which is adjusted semi-annually according to changes in inflation (as measured by the consumer price index). When inflation increases, the principal value of the TIPS also increases and the contrary applies in the case of deflation, resulting in smaller interest payments. Once the TIPS matures, the investor receives either the adjusted principal or the original principal, depending on which is greater. While this instrument offers inflation protection, as well as a natural hedge against deflation if held to maturity, there are some issues that should be considered.

First of all, TIPS are not as widespread and thus not as liquid as traditional treasuries. Secondly, they price a premium into the interest rate offered in exchange for the inflation protection they provide. Therefore, the interest rates offered by TIPS are generally lower than those for traditional bonds. For this reason, they are not attractive fixed income instruments given the current low interest environment. It is also worth mentioning that inflation expectations also have an impact on the interest payments of TIPS. As soon as the expected inflation rises faster than the treasury yield, the interest payments of TIPS may even decrease in an inflationary environment, a risk that is particularly pronounced in times of managed yield curves.

Unlike a TIPS, a floating rate note has a variable interest rate which is tied to a benchmark, such as the federal funds rate. This fixed income instrument can be issued by financial institutions, governments or corporations. How often the interest rate is adjusted to the benchmark depends on the product, with the reset frequency ranging from daily to yearly adjustments. If the benchmark interest rate rises, so does the FRN rate and vice versa. As is the case with TIPS too, that protection offered by floating rate notes is also priced into the interest rate, so in exchange for the reduction of interest rate risk, the FRN rate is typically lower than that of its fixed rate equivalents. Bearing these issues in mind and with the yields to maturity on investment grade FRN currently ranging between 0.05-0.35%, we do not see any value in these instruments in the current environment from a risk-return perspective.

Implications for investors

While we see the overall outlook and investment appeal of bonds as significantly weakened, at least for the short- and mid-term, we also recognize that there are still ways in which a bond allocation can make sense. For one thing, the decision to invest in bonds or not heavily depends on the profile of each client and their particular needs and goals. Even in an inflationary environment, a small bond position might be strategically sound for an investor who prioritizes income in the short term. Even more importantly, we must also highlight at this point that holding bonds is a decision that is not always or entirely based on the returns alone. Bonds can also provide currency exposure and they can be a useful diversification instrument in this regard. The return might be low, but it is still preferable to merely holding cash. Finally, we must point out that the skeptical outlook we presented here only applies to current investments and the situation as it stands today. In a few years, bonds may, due to higher yields, very well prove to be much more attractive, even amid higher inflation levels.

At this point, however, and for most investors, there is a gap that was created by the declining appeal of bonds. Under the present conditions, it can be challenging to fill it, given that there are no attractive equivalents or other instruments that can offer risk-free returns. Therefore, some flexibility is necessary, but there are good alternatives for investors who are willing to increase their risk tolerance somewhat in exchange for reasonable returns.

An interesting option among them are real estate investment trusts (REITs). These are companies that own income producing property and still offer decent returns, though the risk of REITs is without a doubt generally higher than that of investment grade bonds. Also, investors need to pay attention to what kind of REITs they invest in and conduct their due diligence very carefully. We like specialty REITs (e.g., data centers, healthcare sector, logistics, etc.), especially in the booming region of Asia, due to favorable demographic and economic developments. For the same reasons, we would be more cautious with residential, retail, and office REITs in advanced economies.

Another alternative is offered by dividend-paying stocks. A careful selection can generate regular income streams, approximating the fixed income offered by bonds. Of course, the overall risk levels are considerably higher with stocks, but with diligent screening, an investor can mitigate this to an extent, by identifying high quality companies with a strong balance sheet and a solid business model.

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