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LETTER FROM THE CIO AM

MARKET ANALYSIS
AND PRINCIPAL INVESTMENT THEMES

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WORRIES OVER A TIPPING POINT

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► As the well-known joke goes, Modern Monetary Theory (MMT) is neither modern (it is akin to traditional funding of government deficits) nor monetary (adjustments are made to fiscal policy). And it is even less a theory.
So what is MMT exactly? Given that the parallel between the current US experiment and MMT has been established, we may well wonder. What is clear is that MMT starts with an almost free lunch. Reflation is funded by debt that costs almost nothing thanks to ultra-expansionary monetary policy. And it ends with inflation followed by tax rises (or cuts to public spending) when reflation has gone beyond the desired goal of getting a country back to full employment. It goes without saying that investors find the risk/return profile on assets attractive in the first phase, but markedly less so in the second.
The market is currently in the first phase. Should we be worried it could tip more rapidly than expected into the second phase?

KEY FIGURE

25%
of US GDP

the simply unprecedented amount Biden's stimulus plans could represent over several years (excluding the recessive impact of higher taxes).

ECONOMIES RISK OVERHEATING

Joe Biden's $1.9 trillion stimulus plan has done a lot to push inflation premiums higher. Even Democrats like Harvard professor Larry Summers, a former Treasury Secretary under Bill Clinton, have warned on the plan's inflationary risk. Other economists like Paul Klugman do not agree but Summers' comments remind us that the current experiment involves unprecedented amounts and a certain leap into the dark.

The Biden administration is looking to capitalise on its political capital to push through other ambitious plans. It is still not clear how big the infrastructure plan will actually be or whether it will get through Congress. In recent days, its scope has been revised higher. The target is now said to be $3 trillion on infrastructure over 10 years. Some reports suggest Democrat divisions could be overcome while a handful of Republican senators might be tempted to compromise. Big moves behind the scenes are now afoot to accelerate a project that was until very recently just a premise. Biden's stimulus plans could now total around 25% of the country's GDP over several years (excluding the recessive impact of higher taxes). This is quite simply unprecedented.

POSSIBLE INFLATIONARY TENSIONS

If investors think there is a good chance of the stimulus plan getting through Congress, all lights turn green for inflation expectations to rise: the Fed is still pursuing its aggressive quantitative easing, even if the current state of markets and the economy no longer justifies it, and massive and sustainable stimulus is in the pipeline. Over the shorter term, inflation could surge. Freight rates have risen sharply, semiconductors are suffering from a shortage and building material prices have increased. Both PMI surveys and statements from company heads highlight mounting concerns over production costs.

Any increase in inflation expectations would be bad news as it would be seen as marking the limit of the Fed's current approach. The Fed has played a pivotal part in helping markets rebound over the last year and it is vital that it manages to exit its extremely laxist policy approach at its own pace and not appear to be rushing to catch up with developments.

WE CANNOT RULE OUT A FRESH BOUT OF VOLATILITY

Too much reflation risks upsetting the market's macroeconomic framework. Investors are increasingly adopting a perfect scenario. Equity market positioning is now at extremely high levels so any unexpected risk could expose fragility. The environment is clearly upbeat for risk assets but volatility is now quite possible. That is why we have tactically reduced our equity and government bond exposure. We prefer to increase our cash holdings, waiting to see how Biden's extremely ambitious infrastructure plan in the US is introduced and its possible impact on inflation expectations.

Our heavily underweight government bond position does not mean we expect long bond yields to rise significantly, rather it reflects our current management of overall portfolio risk.

As the danger of higher inflation expectations could hit all asset classes, we prefer to focus risk on equities and certain bond subclasses. We want to avoid being exposed to assets which continue to offer wafer-thin yields but which are highly exposed to this risk.

	Our convictions for April*	Changes compared to the previous month
ASSET CLASSES		
Equities	=	↓
Fixed Income	-	→
Cash	+	↑
EQUITIES		
US	-	↓
Europe (ex-UK)	=	↓
UK	=	↓
Japan	=	↓
China	+	→
Global Emerging	=	↓
Convertibles	+	→
SOVEREIGN BONDS		
US	--	↓
Euro Zone	--	↓
Emerging Markets	=	→
CORPORATE BONDS		
US Investment Grade	-	→
Euro Investment Grade	-	→
US High Yield	=	→
Euro High Yield	=	→

*Range of investment committee ratings on the asset class/geographical zone (from -/- to +/+). Source: Edmond de Rothschild Asset Management (France). Ratings at 30/03/2021.

KEY POINTS

We have tactically cut equity and government bond exposure

Portfolio risk is now being managed on an overall basis

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