

Market Perspective



The curious incident of the falling bond yields

Issue 128 | August 2021

03 Turning points in rates

Market responses

09 House prices on fire?

Systemic risk contained

04 Climate questions

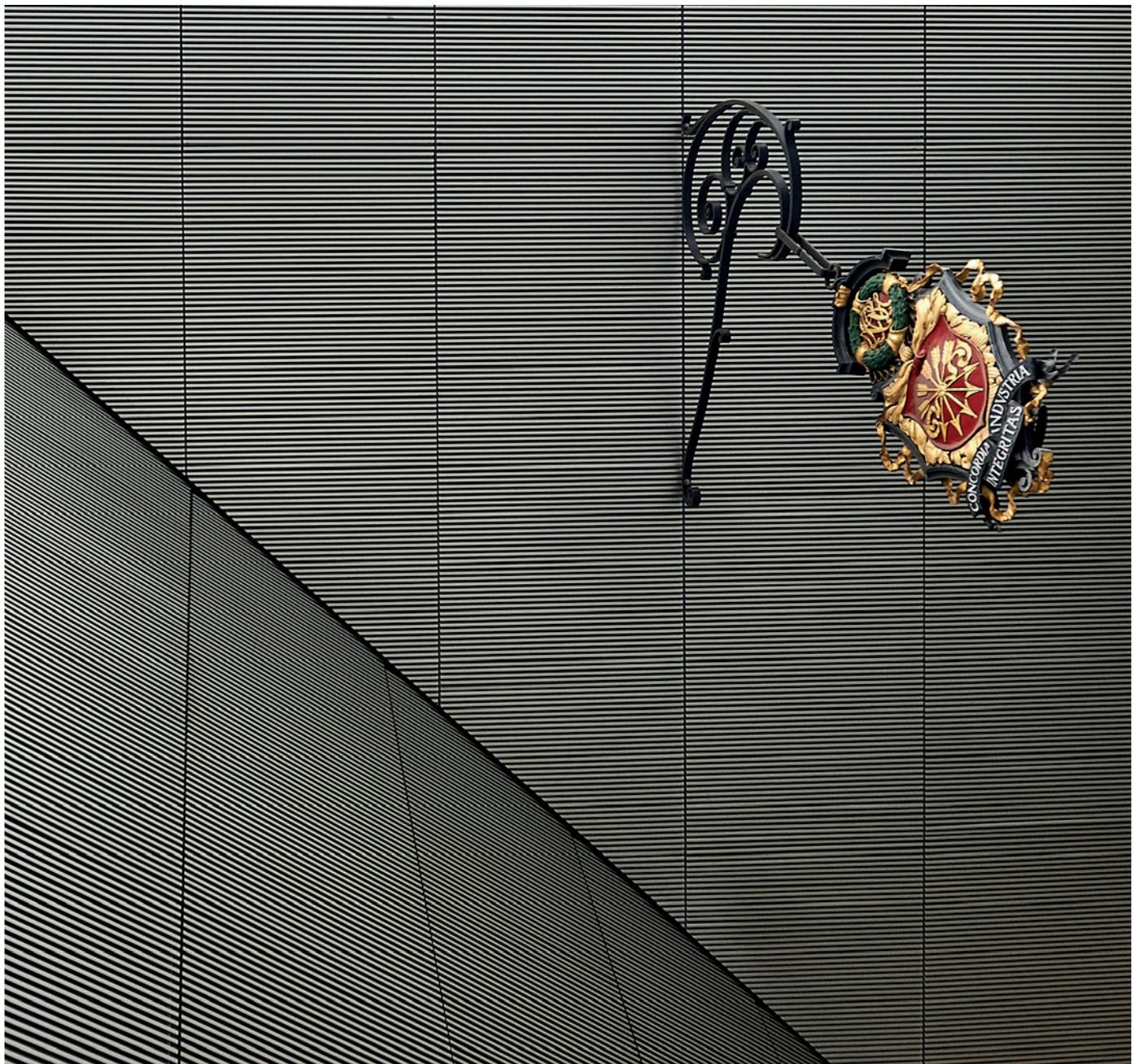
What are the key issues?

10 ECB lifts inflation target

Another straw in the wind

07 Carbon pricing

Internalising the externality





The curious incident of the falling bond yields

Scotland Yard Detective: "The dog did nothing in the night-time"

Sherlock Holmes: "That was the curious incident"

US inflation significantly exceeded expectations in April, May and now June, with the annualised core rate at post-1981 highs. Despite the most startling inflation numbers in recent years, however, US Treasury (bond) prices are up. For good measure, gold is down and bitcoin briefly collapsed (again). Go figure, as they say.

Maybe the inflation guard dog has been quiet because, as in the Sherlock Holmes story, the culprit is known to them. The immediate inflation surge has looked largely 'transitory', caused by supply bottlenecks as the US economy reopens unevenly, and long-dated Treasuries ought not to respond to short-dated concerns.

Perhaps, also, there was just too much growth and inflation risk already priced-in after bonds' earlier sell-off (and gold's rally). More recently, bondholders may be digesting revived COVID-related deflation risk, and/or the fact that US growth has passed its cyclical peak. And many bondholders these days (such as central banks and liability-driven investors) simply don't care, having bought bonds for non-economic reasons to begin with.

But we think longer-term inflation risk is rising – and if these short-term surprises persist, 'transitory' may start to look like 'trend'. If virus suppression re-tightens, adaptation will continue; and while growth must decelerate anyway (you can only reopen once), it could stay above trend, eating up spare capacity, for a while yet.

We advise against taking money markets' resumed faith in disinflationary conditions too much to heart, then. And while stocks will not be immune to renewed interest rate risk, we see the similarly quiet ongoing rise in projected corporate earnings as a more significant clue than bonds' rally.

Kevin Gardiner/Victor Balfour

Global Investment Strategists



Cover:
A very public symbol of the heritage and values of the family business is the Rothschild shield positioned on the exterior wall of our New Court office in St Swithin's Lane, London. The five arrows combined with the family motto is the only advertisement for the business within.

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Sources of charts and tables: Rothschild & Co or Bloomberg unless otherwise stated.

Market responses when interest rates turn upwards

As of its June meeting, the Federal Reserve's Federal Open Market Committee 'dot plot' – a projection of FOMC members' expected rates – shows the median Committee member expecting rates to start rising in 2023, compared to 2024 previously.

Markets have become more sceptical since then, but we still think rates will rise sooner than is currently priced-in. How might the big asset classes respond to a US rate hike? We look here at four distinct episodes since 1993.

In all four episodes, stocks – as measured by total return in the S&P 500 index – have outperformed other asset classes during times of rate hikes – the pink sections on the graph. In three of the four episodes they have outperformed other asset classes in the year following the final rate hike as well – as shown in the grey sections on the graph. The one exception was the 1999/2000 episode, associated with the dot-com bubble, as forward earnings and overvalued stocks collapsed.

High-yield credit has followed a similar pattern to stocks, and in periods of strong growth and rising interest rates has performed much more like an equity asset than a bond – apart from the 1994 episode, in which credit played a more central role (just as stocks did in 2000) including, notably, the 'Orange County' affair. Perhaps not surprisingly, investment grade credit and US treasuries have generally lagged: being closer to pure interest rate plays, their relative attractiveness during periods of rate increases diminish, but in periods where rates have held constant, or even dropped, they have performed better.

From a top-down perspective, as we approach a turning point in rates, we are positioned as history suggests we should be. In the initial growth-driven part of the rate cycle, business assets ought to do better (valuations permitting of course) because corporate cashflow and creditworthiness is sharing in the upswing that is boosting rates. That said, high-yield spreads look more compressed than does the equity yield gap, and we suspect that there is more room for stocks to take a clearer lead now.

We should beware of making sweeping statements, of course: there are always many other factors at play too – for example, the nature and composition of growth, and the geopolitical landscape.

Some perspective:

1993

The US economy was emerging from a deep and protracted recession and the savings and loan crisis in the 1980s. By 1993 economic growth was starting to surge, and the stock market was performing well. Despite low inflation, and high unemployment (relative to pre-crisis levels), the Fed took the market by surprise with a 0.25% rate hike. 'Tequila crisis' and 'Orange County' are key search words here.

1999

The Fed raised rates six times to cool the economy between 1999 and 2000, following a period of high growth, 'irrational expectations' and its own earlier generosity, despite little actual inflation. 'LTCM' and 'Y2K' are key search terms.

The NASDAQ-led stock market bubble crashed in March 2000, followed by a prolonged period of depressed earnings.

2004

This was the first rate hike in four years, and marked the end of a period of ultra-low rates (by then-current standards).

The stock rally in 2003 was set against a backdrop of an impending US–Iraq war. Performance was largely driven by a mix of rebounding tech (up nearly 50% that year), consumer cyclicals and materials.

The next rate drop was a surprise move by the Fed, in response to problems arising in the credit markets in 2007.

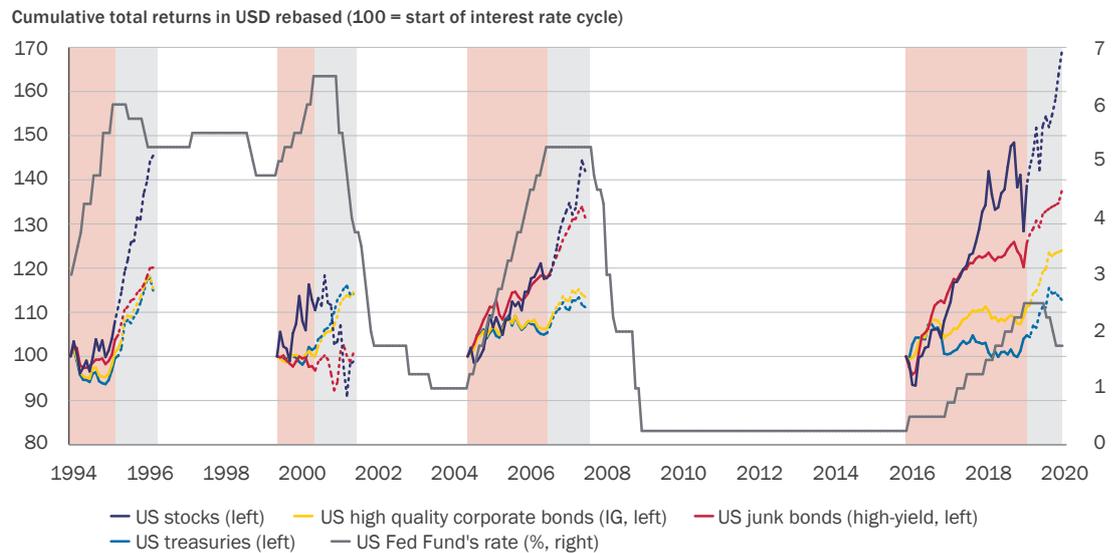
2015

The Fed lowered rates to near zero following the Global Financial Crisis in 2008, with the goal of encouraging lending and spurring the economy towards growth.

It began raising rates in 2015 in a well-advertised effort to move away from its post-crisis stimulus plan, following a revival in growth and employment.

Charlie Hines – 1 July

Cross-asset class returns from the start of each interest rate cycle



Source Bloomberg, Rothschild & Co.
 Note: US stocks = S&P total return; US junk bonds = Bloomberg Barclays US Corporate High Yield Bond Index; US high quality corporate bonds = Bloomberg Barclays US Credit Index; US treasuries = Bloomberg Barclays US Govt 7-10 Yr Bond Index.



Climate questions

How scared should we be?

In 2019 a UK broadsheet changed its style guide, asking its writers to refer not to ‘global warming’ and ‘climate change’ but to ‘global heating’ and ‘climate emergency’.

How should we view the ongoing man-made increase in global temperature? Is it transformative or apocalyptic? If the former, investing as we know it can continue with modification and adaptation. If the latter, we face a discount rate that no prospective return can hope to scale.

Prominent campaigners firmly believe the latter and have helped move the public opinion dial. Public opinion in turn has changed the way in which wealth managers do their jobs. Many of us share those concerns anyway.

Most people would agree that care for the environment – and for future unborn generations – is a good thing. To an economist, the spoiling of the environment is a modern-day ‘tragedy of the commons’. The costs to society have not been taken into account in decision making because they are not easily captured by the conventional pricing mechanism.

Carbon emissions are a classic ‘externality’, and a clean and temperate environment is a ‘public good’ – two headings under which markets fail. Internalising externalities, and delivering public goods, is best done by governments – a point with which most economic liberals, not just interventionists, would agree.

Public opinion can sometimes develop a momentum of its own, however. And when it comes to assessing our collective future, received wisdom can be mistaken. Think of Thomas Malthus’ 1798 prediction about food supply, Paul Erlich’s 1968 diagnosis of a population ‘bomb’, or the many books and essays devoted in the last quarter-century to a ‘demographic timebomb’.

Perhaps extreme words and actions have been needed tactically, to grab headlines and get something done. Many campaigners however, sincerely believe in the end of days, and their rhetoric is often unchallenged. If their analysis is faulty, might they trigger a backlash that could stall climate progress?

Single-issue politics is not attractive, even when the cause is a good one. It avoids the messy-but-real trade-offs that democracies have to deal with. It can be authoritarian, and regressive (when demonstrations disproportionately affect poorer commuters, for example).

Meanwhile, we read of children being anxious, and of potential parents deciding not to bring new people into a world they believe to be doomed.

Politicians are 'getting it'

Scientists agree that climate change is significant and caused by us, and public and political acceptance of the need to do something is gathering momentum. The recent G7 summit confirmed that elected politicians increasingly 'get it'. November's COP26 ('Conference of the Parties', the next United Nations Climate Change Conference) in Glasgow will renew the attempt to co-ordinate a global response, and to engage smaller and less well-off countries.

The main goals – zero net carbon emissions by 2050, and a 1.5 degree Centigrade cap on the prospective long-term rise in temperature – were agreed in Paris in 2015 (the US subsequently announced in 2017 that it would withdraw from the agreement: this took effect only in late 2020, and the US immediately rejoined under President Biden). COP26's task is to decide on implementation, and we should expect to hear specific initiatives around (for example) coal, deforestation, electric vehicles, renewables and the provision of finance.

The exact date and cap do not have intrinsic scientific significance, other than that the sooner we act, and the lower the increase we achieve, the better (and it is probably not a linear process: each additional degree of warming/heating is thought likely to do more damage than the preceding one). The numbers 2050 and 1.5 themselves are politically agreed, quantifiable targets, not scientific thresholds. There is widespread agreement that the targets are demanding, and that temperatures will likely rise further.

More questions than answers

But is the challenge we face tractable and incremental, or is this all too little too late? To return to the earlier question: is it a transformative threat, or an apocalyptic one?

I suspect it is the former (and certainly hope it is). I am not a scientist, but many of the issues we face are not narrowly scientific: they relate to choices and trade-offs. My reading suggests that this is not an existential problem, that policymakers can make meaningful progress, and that some proposed solutions could prove counterproductive and unfair (particularly to developing countries). Collectively, we may be overconfident in our current pessimism, and underestimating our ability to adapt and innovate (another variant of Malthus' mistake).

This is a personal judgement, and many readers will disagree. But if none of us can be sure of the right answers, we might be able to agree on the questions. Here are some of mine.

First, and most important, what are the geophysical implications of rising global temperatures? Can humans function in a warmer (or hotter) world? How urgent and sensitive is the threat – is there a tipping point at which change stops being incremental and becomes more dramatic?

Will the number of people suffering from heat outweigh the number of people spared from cold? How many communities will be hurt by rising sea levels, and how badly? Might some be protected, in the way that a quarter of the Netherlands is, or relocated sympathetically?

How big will shortages of potable (drinkable) water be? Will water management and desalination technologies continue to improve?

Is the rising temperature a bigger threat to wildlife than (say) current human behaviour – overfishing, for example?

Can climate concerns sometimes be at odds with best environmental practice? For example, might local incineration use less energy than shipping waste around the world? Might some plastics use less energy than the recycling of more natural packaging?

Is the rising temperature a bigger threat to poorer countries than a lack of economic development would be? As we make (carbon-based) energy more expensive, the costs in terms of foregone economic growth will be particularly pressing for less developed countries. The least well-off communities are often dependent on the most harmful sources of energy, such as coal generation and domestic wood-burning. For rich countries to 'pull up the development ladder' after they have successfully climbed it would be unfair, and is the cause of many of the political difficulties in negotiating corrective action. Some sort of burden-sharing will likely be needed.

Is conventional nuclear energy (fission) environmentally harmful, or is it greener than we think? Will fusion become a viable source – would it change the bigger picture?

If the biggest measurable economic cost of climate change is the slower GDP growth caused by more expensive energy, will some of that cost be defrayed by innovation in energy supply, and the build-out of alternative energy infrastructure?

Do estimates of the impact of climate change on agricultural yields take into account the positive effect that atmospheric carbon dioxide has on fertilisation? Can farming relocate from today's temperate regions to tomorrow's? Is the climate effect bigger or smaller than the ongoing increase in farm productivity?

After the events of the last few years, it may seem strange to pose these next few questions, but the data may be more balanced than many of us fear. But are disasters such as droughts, wildfires and hurricanes becoming more common, and are they driven by the climate, rather than by our management of our surroundings? If they are doing more damage, are they doing so because more of us (with our more expensive homes) are living in harm's way?

If the number of people on the planet is a cause for concern, we might take some reassurance from the fact that fertility rates are falling, better health care notwithstanding. Birth rates are falling not (yet) for the reason cited earlier, but because a more productive population needs fewer children to help support it in old age. That said, the economist Julian Simon used to see a growing population – which he viewed as comfortably affordable – as a good thing: after all, more people likely means more happiness.

The net costs of climate change can be placed in a less daunting perspective. One report based on a UN Climate Panel review suggested that a significantly bigger temperature rise to the end of the century than that targeted by the Paris accord might result in an economic cost of roughly 3% of global GDP compared to a world without warming. Over the same period, however, ongoing growth could plausibly double GDP, making it easier to compensate those hit hardest.

What discount rate should we use to translate these sorts of future costs into present values? The UK's 2006 Stern Review used a real rate of zero: that was contentious at the time, but if we used today's negative market rates, the present value of lost output would be much higher again. Conversely, it can be argued that an uncertain future, in which per capita output is likely to trend higher, warrants a firmly positive discount rate.

Can we make much of a difference individually – or, if we decide that the dial needs to be moved further, is additional large-scale government action needed? As a UK climate science adviser said, "If everyone does a little, we'll achieve only a little." Our personal cost-benefit calculations are not always complete: our electric vehicles, for example, have a significant carbon footprint before they leave the showroom, use electricity that may or may not be generated sustainably, and are much heavier (that is, require more energy overall) than conventional cars.

Saving the *Pale Blue Dot*

We live on Carl Sagan's *Pale Blue Dot*: the world naturally feels scarily finite. But our existence may not be quite as precarious as we fear. We know little about the minerals concealed within the bulk of its mass; water covers two-thirds of its surface; and we have at least one large fusion reactor already in commission (though we can't moderate its supply – that's part of the problem). Humans have proved remarkably adaptive and inventive.

Some courses of action are clear. Incorporating the social cost of carbon emissions more fully into public decision-making by taxing fossil fuels more, and by facilitating the growth of emission trading (not least by agreeing on more enforceability), should face little dissent, even from libertarians (see next essay).

More generally, to conclude that 'further research is needed' is often a platitude, but not here. Publicly funded research into greener energy sources, and improving the net energy efficiency of fossil fuels, is a no-brainer. This might require a more open-minded approach – backed by further study of its health and environmental impact – to nuclear fission (and yes, one day, fusion). As battery technology improves, meaningful amounts of electricity may yet be storable outside mountaintop reservoirs. Hydrogen may become a significant energy source. Wave power may not be viable yet, but could also become so. Many of these areas will provide attractive investment opportunities.

Talking of likely technological breakthroughs can seem a bit like saying "something will turn up". But it may be realistic. Nobody – certainly not Thomas Malthus – anticipated the explosion in agricultural productivity seen in the last two hundred years, and still ongoing. More recently, how many of our grandparents imagined how routine (until 2020) international travel would become? How many of my generation, at university, imagined today's digital media, instant (and near costless) video communications – or the phenomenal something-for-nothing that is a simple spreadsheet. Why should energy and the environment be immune to future breakthroughs?

Policy-wise, multinational co-operation is difficult, and those UN targets are ambitious. But governments did, eventually, deal with the earlier (admittedly smaller) greenhouse gas emergency caused by CFCs (chlorofluorocarbons), and as noted, their voters are increasingly demanding action.

Meanwhile, adapting to higher temperatures will not just be about protecting below (future) sea-level communities, but about recognising that some areas will become more productive, that building design can provide more natural air-conditioning and cooling and that we may want to change our commuting practices (will COVID change these latter habits at least?).

If this is not an extinction-level event (and my reading is that scientists are not saying that it is) then we need to continue to run our businesses and invest our savings, but also to stay alert and open-minded. As society continues to internalise those externalities, the costs and benefits from dealing with climate change will likely percolate far beyond today's obvious winners and losers.

Capitalism will be part of the solution

Is the economic system itself part of the problem – are capitalism and a market-led economy ultimately unsustainable? We noted above that markets cannot easily deal with environmental and climate externalities and public goods.

I think not. For one thing, the status quo is not really a 'system' as such: that is why it has lasted. To seek an alternative to the decentralised self-interest that drives a big part of the modern mixed economy is a bit like looking for an alternative to gravity.

As we see it, capitalism is likely to be part of a successful response to the climate challenge. If it is 'about' anything at all, it is about the efficient use of scarce resources. Man-made temperature increases have arisen in the pursuit of higher living standards. If markets had functioned better, the effects might have been smaller. But if markets had not existed, living standards would be drastically lower.

Kevin Gardiner – 20 July



Carbon pricing

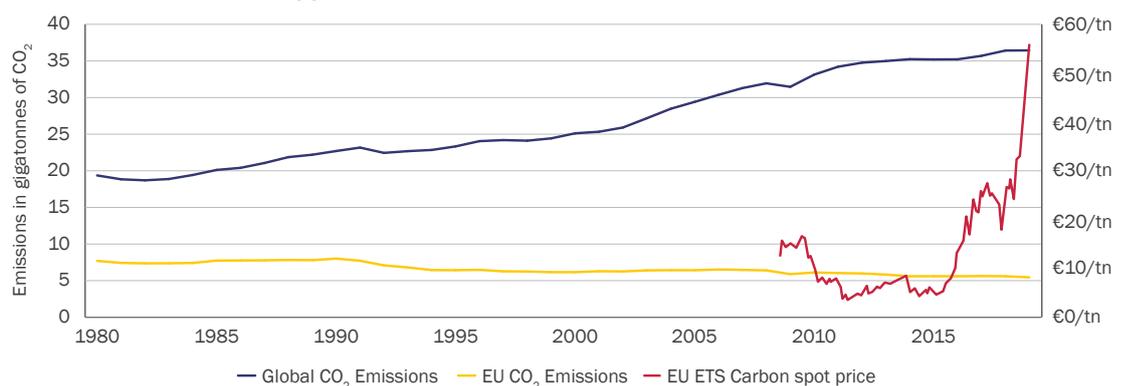
Financial innovation is not always reckless: it can serve an important social purpose (see essay above). A case in point is the carbon credit market, which is once again gaining traction, as corporations increasingly look to shrink their environmental footprint.

A carbon credit is generic term for any tradable certificate or permit representing the right to emit one tonne of carbon dioxide or the equivalent amount of a different greenhouse gas (GHG). One tonne is roughly equivalent to the average monthly CO₂ consumption of a US household.

The current cost of polluting under the EU's Emissions Trading Scheme (ETS) – the first international trading system for CO₂ emissions – has risen to an all-time high, briefly hitting €57/tn of CO₂ in early July (up tenfold since 2017). This latest surge partly reflects the EU's ambitious Green New Deal (September 2020) – targeting a 55% reduction in emissions (relative to 1990 levels) by 2030 – but it also reflects a shift in the corporate mindset too.

CO₂ emissions and carbon prices

Annual carbon dioxide emissions (gigatonnes) and ETS euro futures (near contract, €/tonne)



Source: Our World in Data, Bloomberg, Rothschild & Co
Note: Emissions correct to 31 December 2019. Carbon prices correct to 22 July 2021.

The compliance market

Carbon credits were given practical impetus in the 1997 Kyoto Protocol – the first worldwide agreement to lower carbon emissions. GHG quotas were assigned to individual countries, and in turn, countries allocated ‘credits’ to regulated ‘cap-and-trade’ businesses – essentially polluting industries, such as miners and oil refineries. These credits would allow companies to emit a certain amount of carbon dioxide (or equivalent GHG), and most crucially, they are tradeable: unused allowances can be sold on the open market, while those companies in deficit can purchase additional credits.

Climate exchanges provide a spot market to trade such credits, while broader derivatives markets – including futures and options – help to bolster liquidity, aid price discovery and allow businesses to hedge future emissions liabilities. At present, the deepest and most liquid contracts globally are those traded in euros on the European Climate Exchange.

The idea is a simple, but powerful one: by capturing what was previously a market ‘externality’ – that is, a cost not reflected by the pricing mechanism, and so not taken into account in corporate decisions – the allocation of resources can become more socially efficient, and in a decentralised way. Highly polluting and unprofitable enterprises that are unable to change their ways will see their true costs revealed and find it more difficult to secure capital. Industries that emit less carbon dioxide, or which can innovate and adapt their mode of operation, will flourish. If governments decide to reduce the number of credits over time, or if behaviour changes sufficiently, emissions in total might fall. At the very least, the true costs of doing business will be more accurately reflected in published accounts.

Beyond emissions trading, the Kyoto Protocol also established the Clean Development Mechanism (CDM), enabling businesses to reduce emissions through offsets. These Certified Emission Reductions (CERs) create carbon credits by investing in areas such as renewable energy, tree planting or novel carbon capture techniques. However, going forward ever tighter standards – particularly in the case of the EU’s ETS – will likely prevent the use of such CER offsets for companies seeking to remain with their ‘cap’.

The voluntary market

Increasingly the focus is turning towards the smaller voluntary carbon market, which co-exists alongside the regulated (compliance-checked) schemes mentioned above. Voluntary offsets enable environmentally conscious but non-regulated companies – and even individuals – to achieve carbon neutrality or in some cases even sequester carbon through offsets. Credits can be acquired directly from projects or from specific carbon funds or companies – recently, many banks and technology companies have been actively acquiring such offsets.

However, the area is a thorny one and mechanics of such voluntary credits are complicated.

Though voluntary offsets are verified by independent third parties, their non-standardised characteristic prevents them from being used to fulfil obligations under the Kyoto CDM. This unregulated market isn’t centralised and is much less clearly defined than the mandatory market, with a wide range in quality and cost. Take the example of a Brazilian farmer compensated for not felling his trees, against the development of a new hydroelectric power plant in Chile. Clearly the environmental benefits can vary tremendously.

Credibility has been improving in recent years, but ‘greenwashing’ remains a risk. Double counting has been evident and there is a surplus of questionable legacy credits now circulating. Perhaps most important is the concept of ‘additionality’. There are many instances where carbon credits have been issued for projects that would have proceeded absent specific carbon funding.

A growth opportunity?

The carbon credit scheme has critics, and there are alternative approaches. A simple carbon tax could be effective, though this presents its own challenge in terms of harmonisation and incentivisation. Developing nations – some of the largest GHG emitters – are underrepresented, and the wider developed economy carbon markets are still patchy. The EU’s ETS, for example, accounts for less than tenth of the world’s emissions (40% of EU emissions) according to the World Bank.

Clearly, reduction (lower output of fossil-fuelled output) and substitution (using other forms of energy) are needed to achieve long-term emissions objectives. However, for some industries and technologies this may be impossible or uneconomical. The offset market allows polluting business to phase out their emissions without going ex-growth.

Looking ahead, the outdated Kyoto protocol is soon to be superseded by the Paris Climate Accord's objectives; Europe's compliance market is expanding, while free allowances (notably for European airlines) are being curtailed; and, most encouragingly, China has recently announced its own emissions trading market.

As for the unregulated voluntary market, demand is likely to surge as companies attempt to meet loftier CSR objectives. One estimate suggests that this segment, currently valued at \$300m, will need to grow 100-fold by 2050 if countries and companies are to achieve net zero. Attempts to harmonise international verification standards – promoting transparency and simplicity – and the introduction of credible global carbon markets for such contracts will be crucial in reaching this objective.

Victor Balfour – 22 Jul



4 minute read

House prices are on fire...

...according to Andy Haldane, the outgoing Bank of England Chief Economist. Indeed, residential real estate across much of the developed world is on a tear, buoyed by ultra-low interest rates, shifting preferences and a scarcity of homes. In the US, for example, the cost of single-family dwellings surged 23% in the twelve months to May; in New Zealand the comparable figure was approaching one third.

Such statistics are often accompanied by fearful warnings. In part this reflects the sheer size of global residential property markets and their use of leverage – there are deep linkages with the real economy and the financial system. For many this resurrects fears of economic instability and the excesses of the noughties.

We do not see this as the precipice of another crisis. The economic revival is well underway and bank lending (and any subsequent securitisation) could be described as conservative relative to the heady days of the GFC. Outright property 'bubbles' are rare, and household debt burdens are not as stretched as they were.

House prices had little time to respond to the events of 2020 – the market was initially incapacitated as lockdowns ensued, but the economy quickly started to rebound. Of course, the property cycle doesn't neatly follow the economic cycle, with longer-term trends in demographics and the supply of houses playing important roles. Subdued supply in particular has helped squeeze prices higher as low mortgage rates have fostered resurgent private demand. Supply is often restrained by regulatory obstacles, ineffective policy, and 'nimbyism'.

In addition, as the crisis progressed, remote working arrangements and a long period of introspection have reportedly encouraged some homeowners urgently to reappraise their living arrangements. This has driven something of a development boom – notably in the US, where supply tends to be more flexible anyway. Construction labour shortages are appearing, alongside the rising cost of key raw materials – lumber prices surged some 500% in the twelve months to May (though they have eased subsequently).

However, one risk indicator – affordability – is now flashing 'red', even as mortgage rates have collapsed to all-time lows, simply because prices have risen so far. The OECD gauge of housing affordability – based on price-to-income and price-to-rent ratios – has now surpassed the 2007 high.

Our attachment to housing is emotional, and complicated by its quasi-investment status. A house is first and foremost a place to live, but it is also most owners' biggest single asset, dominating their personal balance sheet. Would-be occupiers and speculators can have competing interests: local residents often find themselves excluded as investment-led prices surge higher.

The recent run up in prices does indeed seem to have attracted more institutional and speculative buyers into an already frothy market – a very visible beneficiary of financial repression, as ever-lower yields drive portfolio shifts. Prices need to fall, or incomes rise (or both), if the inequity is to be reduced.

Residential property contrasts markedly with commercial markets, which faced something of an existential crisis last year – a consequence of working from home, social distancing, unpaid rents, and foreclosures. Though most segments are slowly returning to normal now, there was a clear bifurcation between down-trodden retail, hotel, and office space; and warehouses and industrial units facing strong demand.

Even investors in REITs – Real Estate Investment Trusts, which are part of the equity market – faced a particularly difficult environment in 2020, as many assets traded implicitly at fire-sale discounts: the MSCI US REITs index, for example, was one of only three sub-sectors to deliver negative returns last year.

For investors in so-called ‘open-ended’ real estate funds, the reality was even more precarious: liquidity evaporated, leaving many funds suspended, with investors effectively gated and unable to sell positions.

Conclusion

Looking ahead, after a tumultuous 12 months, commercial real estate markets seem to be stabilising. Last year’s trends are slowly reversing – demand for warehouses is ebbing, while high streets slowly resume trading.

As for ‘red hot’ residential property markets, some distortive policies (such as the UK’s stamp duty holiday) have expired, and there are signs (such as US housing permits) that we may have passed the peak in this housing boom.

Direct investment in real estate can offer a different, and often uncorrelated, third source of investment return to go with interest income and company profits. Moreover, those returns can offer some protection against inflation. But it is difficult to go much beyond the macro observations outlined here: illiquidity and indivisibility (where direct ownership is concerned) limit the inclusion of real estate in all but the very largest, quasi-institutional portfolios.

In our context, the most important aspect of the strengthening real estate markets has been their contribution to wider economic recovery, which seems unlikely to end in tears just yet.

Victor Balfour – 28 June



1 minute read

ECB lifts inflation target

In another sign of central bank mission creep – towards a greater tolerance of inflation – the ECB has subtly loosened its inflation target.

On its inception, the ECB targeted a medium-term inflation rate “below 2%”. In its 2003 review of monetary strategy, the target became an inflation rate “below, but close to, 2%”. Now, as a result of the latest long-awaited strategic review, it will target 2%, symmetrically, and with some (unquantified) tolerance of ‘transitory’ overshoots. The context remains a medium-term one, in which ‘medium term’ remains undefined.

(The ECB will also work towards including owner-occupied housing costs in its preferred Harmonised Consumer Price Index. Whether this effectively further loosens or tightens the target relative to today’s framework in which such costs are excluded will depend on where we are in the house price cycle at the time of inclusion.)

We shouldn’t make too much of the move, which is neither big nor surprising. Last year’s dovish review at the Federal Reserve (Fed) was a more convincing statement of intent. The earlier ECB frameworks were always poorly specified, the lopsided targets being a sop to Bundesbank hawks (now an endangered species). Whether the more deflationary eurozone should have the same numerical target as the US and UK is moot, but neat.

Judging by market responses, the change has not materially affected expected inflation or monetary credibility: the moves are well within typical daily trading ranges.

But it is another straw in the wind, all the same.

Kevin Gardiner – 9 July

Economy and markets: background

Growth: major economies

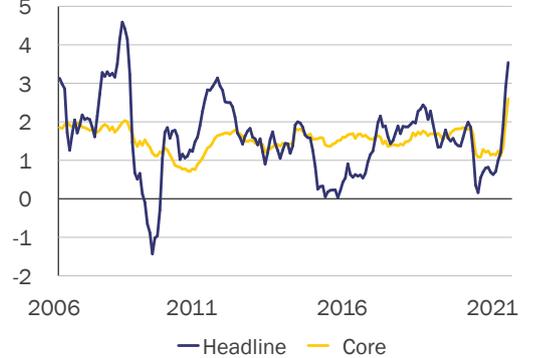
Business optimism: standard deviations from trend



Source: Bloomberg, Rothschild & Co
Composite of the forward-looking components of manufacturing surveys from China, Germany, Japan, UK and US loosely weighted by GDP

G7 inflation

%, year-on-year



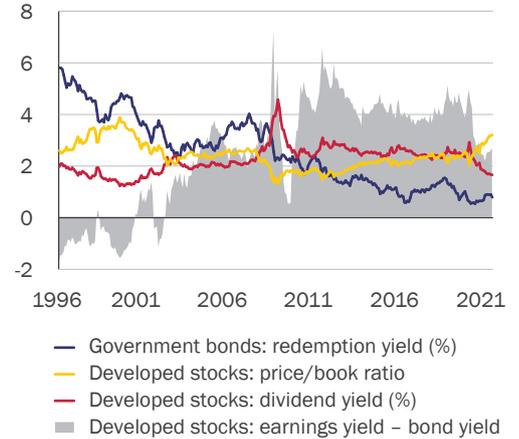
Source: OECD, Bloomberg, Rothschild & Co

Stocks/bonds – relative return index (%)



Source: MSCI, Bank of America Merrill Lynch, Bloomberg, Rothschild & Co

Stocks/bonds – relative valuations



Source: MSCI, Bank of America Merrill Lynch, Bloomberg, Rothschild & Co

Selected bonds

Current yields, recent local currency returns

	Yield (%)	1yr (%)	3yr (%)
10-yr US Treasury	1.3	-3.1	20.9
10-yr UK Gilt	0.6	-3.0	8.9
10-yr German bund	-0.4	-0.4	6.5
10-yr Swiss Govt. bond	-0.4	-0.5	2.7
10-yr Japanese Govt. bond	0.0	0.4	1.3
Global credit: investment grade (USD)	1.0	0.3	15.4
Global credit: high yield (USD)	4.4	10.4	20.8
Emerging (USD)	3.9	4.2	20.4

Source: Bloomberg, Rothschild & Co

Selected stock markets

Dividend yields, recent local currency returns (MSCI indices)

	Yield (%)	1yr (%)	3yr (%)
World: all countries	1.7	30.8	47.3
Developed	1.7	31.9	48.9
Emerging	2.0	23.2	36.2
US	1.3	36.1	65.3
Eurozone	2.2	25.3	23.5
UK	3.6	16.0	-0.2
Switzerland	2.5	17.1	41.2
Japan	2.0	24.2	19.4

Source: Bloomberg, Rothschild & Co

Selected exchange rates

Trade-weighted indices, nominal (2000 = 100)

	Level	1yr (%)	3yr (%)
US Dollar (USD)	107.1	-4.1	0.1
Euro (EUR)	129.4	-0.5	2.1
Yen (JPY)	90.0	-6.0	0.3
Pound Sterling (GBP)	81.6	6.2	5.6
Swiss Franc (CHF)	166.4	-1.0	8.4
Chinese Yuan (CNY)	138.5	7.0	5.6

Source: Bloomberg, Rothschild & Co

Commodities and volatility

	Level	1yr (%)	3yr (%)
CRB spot index (1994 = 100)	216.3	51.0	12.3
Brent crude oil (\$/b)	73.8	66.6	1.0
Gold (\$/oz.)	1,806.9	-3.4	47.0
Industrial metals (1991 = 100)	334.0	41.4	34.5
Implied stock volatility: VIX (%)	17.7	-27.3	37.6
Implied bond volatility: MOVE (bps)	65.0	43.3	32.4

Source: Thomson Reuters, Bloomberg, Rothschild & Co

Data correct as of 23 July 2021.

Past performance should not be taken as a guide to future performance.

Notes

At Rothschild & Co Wealth Management we offer an objective long-term perspective on investing, structuring and safeguarding assets, to preserve and grow our clients' wealth.

We provide a comprehensive range of services to some of the world's wealthiest and most successful families, entrepreneurs, foundations and charities.

In an environment where short-term thinking often dominates, our long-term perspective sets us apart. We believe preservation first is the right approach to managing wealth.

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