# *You said stagflation?*

## *Overview*

Equity indices gained moderately last week but amid higher volatility. Oil & gas along with automotive performed well, while tech was dented by the rise in the US 10-year yield to 1.6%. On the whole, investors have become hesitant, spooked by higher inflation, just as the price of oil has reverted to its highest level since 2014. Other bugbears last week were the debt ceiling and the faltering US jobs market.

With OPEC unwilling to increase supply substantially and the US not planning to draw on its strategic reserves, energy prices have continue rising, rekindling fears of a surge in consumer prices.

### *Oil prices at their highest since 2014*

Making matters worse, only 194,000 jobs were created in the US during September versus the 500,000 expected, suggesting that economic growth may be cooling stateside and raising the question whether the Fed, part of whose mandate is full employment, might actually back off from tapering, i.e. the reduction of asset purchases.

However, the notion of more persistent inflation than expected dominated proceedings, putting pressure on yields. The post-pandemic economic recovery is no longer in its breakneck phase, casting doubt on how it will proceed from here. The word on everyone's lips is now 'stagflation', which is reminiscent of the 1970s. Such periods are favourable neither to fixed income nor to equities and therefore require a more defensive approach to investing.

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The fate of the rally in banking stocks, which have already strongly performed this year, will depend mainly on long-term yields and how this will affect lending activity. The prospect of higher rates, evidenced by a steepening yield curve, would increase the net margin, i.e. the difference between the cost of deposits and the interest on new loans. US banking majors will report their third-quarter results starting this Wednesday. Earnings growth is expected to average 20% versus the prior-year period. In any case, they have significantly reduced their loan-loss reserves, which is already reflected in higher earnings per share and stock prices. One major challenge for banks is limiting the lost ground relative to other lenders in an environment whereby households are reluctant to take on debt. Sector multiples – including European banks – remain relatively affordable. For example, the price/earnings ratio is around 12x versus over 20X for the S&P 500.

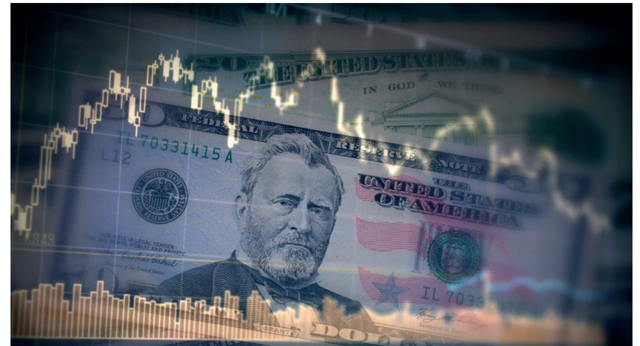
Last week's bounce created a gap at 11577. The SMI might drop back to fill this in before resuming its upward march to our target at 11900.

## *Key data*

| | USD/CHF | EUR/CHF | SMI | EURO STOXX 50 | DAX 30 | CAC 40 | FTSE 100 | S&P 500 | NASDAQ | NIKKEI | MSCI Emerging Markets |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Latest | 0.93 | 1.07 | 11'764.99 | 4'073.29 | 15'206.13 | 6'559.99 | 7'095.55 | 4'391.34 | 14'579.54 | 28'048.94 | 1'257.04 |
| Trend | ➡ | ➡ | ➡ | ➡ | ⬇ | ➡ | ➡ | ➡ | ⬇ | ⬇ | ➡ |
| YTD | 4.74% | -0.76% | 9.92% | 14.66% | 10.84% | 18.17% | 9.83% | 16.91% | 13.12% | 2.20% | -2.65% |

(values from the Friday preceding publication)

## *US bond yields*



Government bonds have done little this year to cushion market corrections as they have generally been sold off in tandem with equities. At this point, yields are expected to edge up. While the inflation surge is probably transitory, price increases are nonetheless expected to outstrip inflation in recent years, given the record levels of government debt and the massive investment plans.

The yield on 10-year US Treasuries was one of the main investment themes this summer. The prospect of imminent tapering by the Fed, whereby it would curtail monthly asset purchases of bonds and mortgage-backed securities, has sparked some tension because supply would increase for other classes of buyers.

But what are the technicals saying? Since last week 10-year paper seems to have the wind in its sails. The MACD indicator (which tracks the relationship between two exponential moving averages of different periods) predicts a continuation of the bounce. For things to become worrying for equity markets, the 1.70% mark would have to be breached, which would also spell a breakaway past the long-term downtrend line. The 200-day moving average is situated at 1.86%, so we can take this level as a short-term target. Conversely, if the yield falls below 1.45%, the target would then be 1.30%, i.e. the nearest support line.



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