SARASIN
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Six Minute Strategy

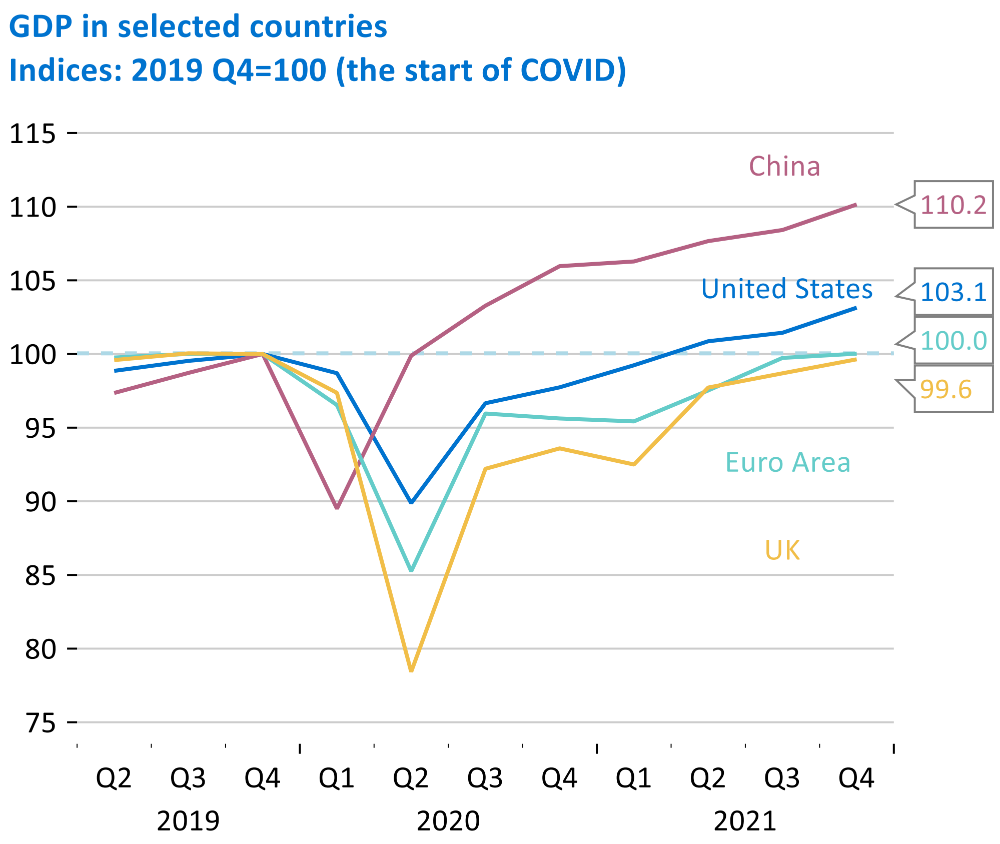
What does tighter money mean for markets?

18 February 2022

An extraordinary global recovery - at the cost of higher inflation

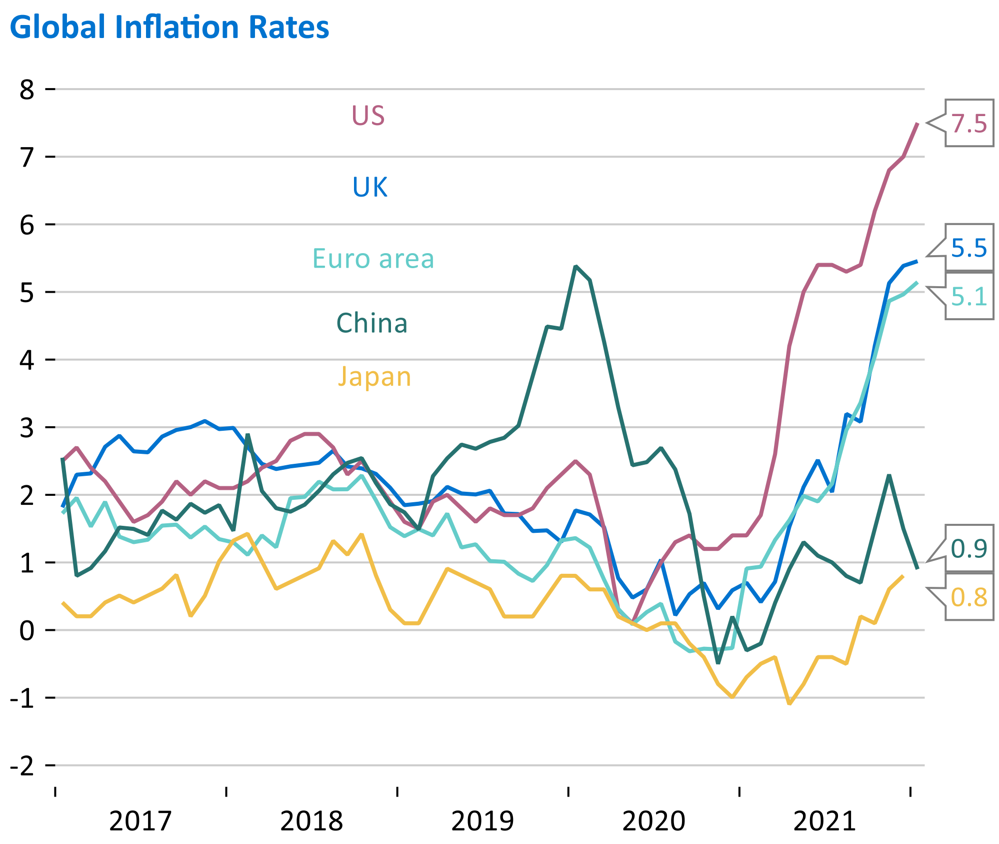
Inflation higher for longer: Base effects, supply bottlenecks and Omicron/labour costs

Most major economies at or above pre-COVID GDP levels



Source: Macrobond, 17.02.22

Consumer price inflation (yoy)



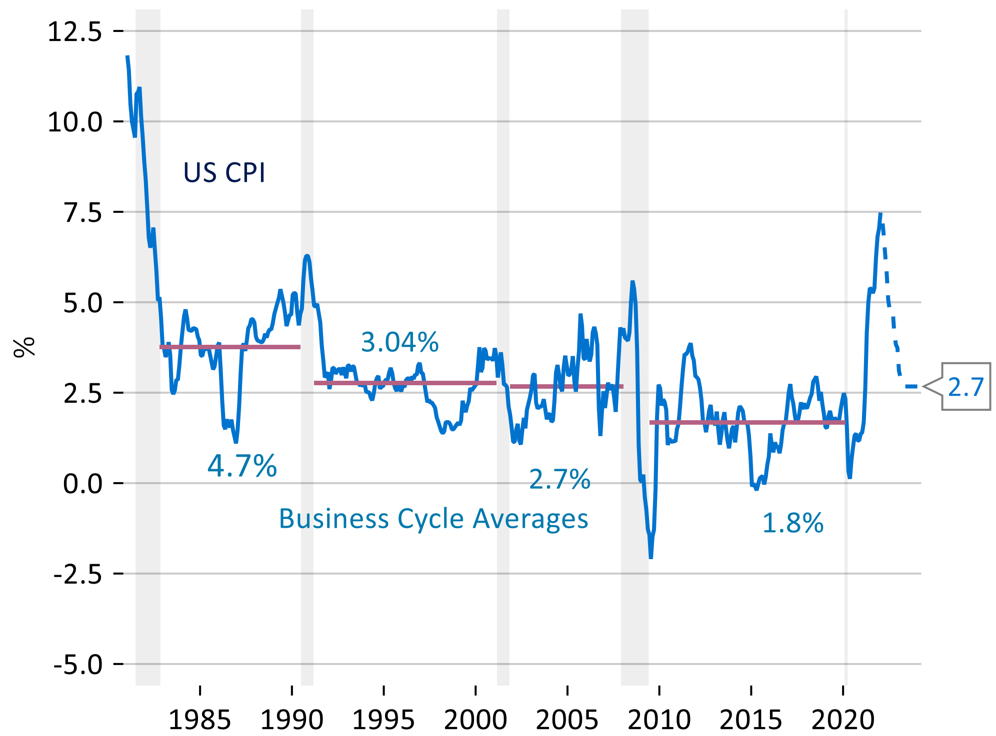
Source: Macrobond, 17.02.22

As inflation risks rise, central bankers are dialling back crisis-era policies

1. **Inflation: *broad based pressures***
   - Average US inflation of 4.5-5% expected for 2022 - upside risk everywhere ex-Japan
   - US headline CPI to trend at 2.7% from 2023 onwards
2. **Monetary policy: *normalisation begins***
   - **QE**: To fall significantly from $2.9tr in 2021, to $470bn in 2022 & *then negative $ 1.1 trillion (QT) in 2023*
   - **QT**: Start in the US and UK in H1 2022
   - **Interest rates 2022:** 5 increases in the US, 2 in the UK, unchanged in Euro area & Japan, China to cut

Inflation will not return to post Financial-Crisis levels

US Inflation Across Business Cycles and Sarasin Projections

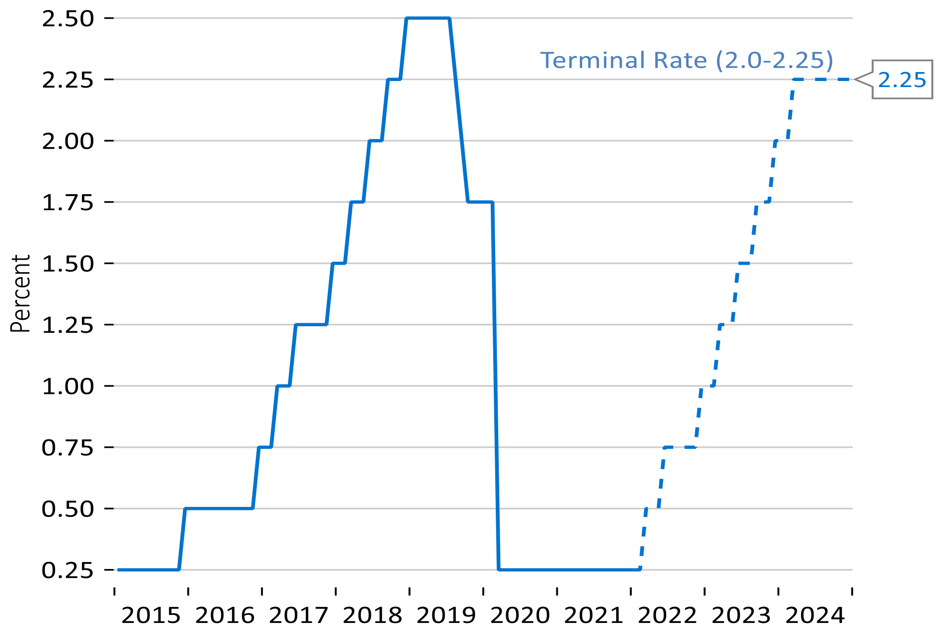


Source: Macrobond, 17.02.22

Interest rate rises will likely be faster & balance sheet run-off (QT) sooner than in previous cycles

Expect 5 hikes in 2022 and terminal rates to reach 2.25%

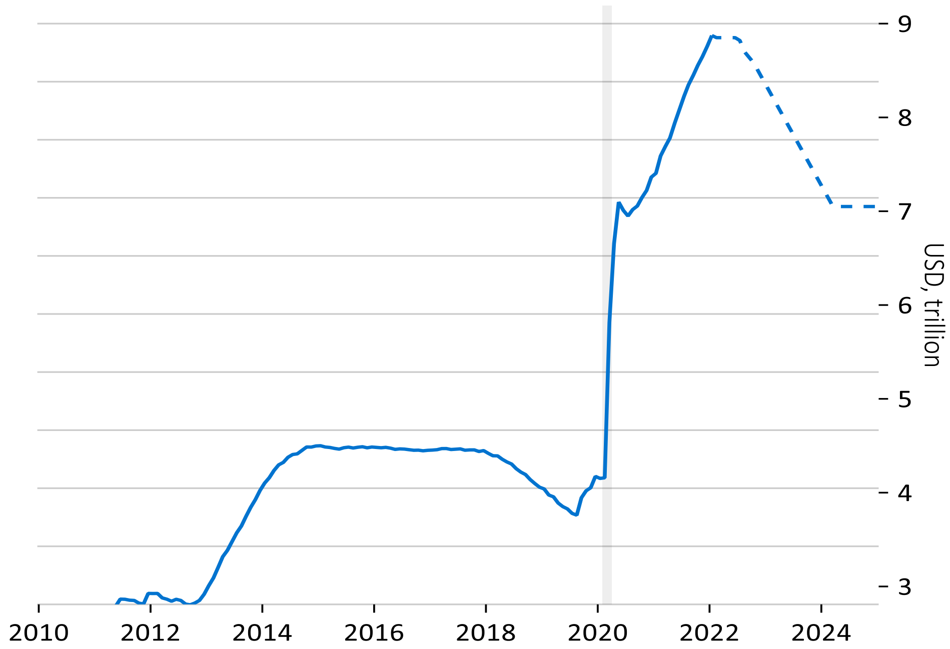
Path of policy normalisation in the US



Source: Macrobond, 17.02.22

Balance sheet run-off in July 2022 & terminal size $7tr

Quantitive Tightening of US Fed Reserve Balance Sheet



Source: Macrobond, 17.02.22

Why do central banks need to reduce balance sheets? *(1) Artificially low bond yields distort asset markets risking bubbles (2) Record balance sheets today reduce flexibility in the next crisis (3) The potential to muddy fiscal & monetary policy*

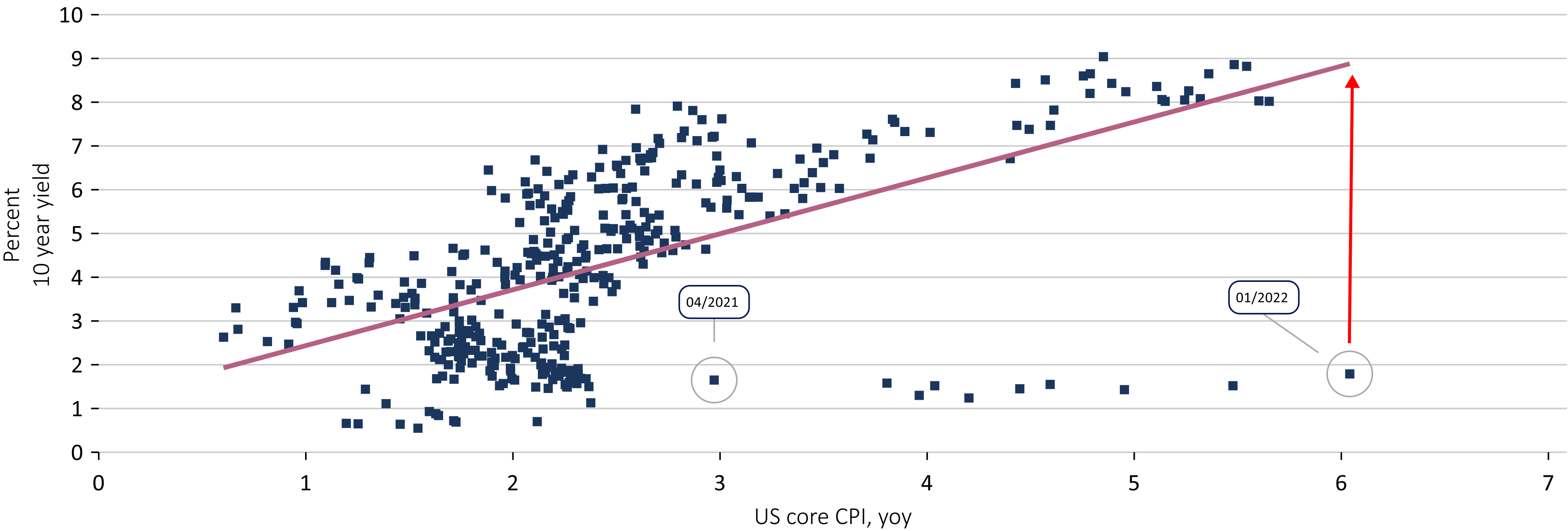
Risk 1: Rising bond yields

Bond yields *could* rise sharply if policy continues to normalise

Today's positioning of bond yields and core inflation is in 'unknown territory'

US: 10-year yields vs core CPI inflation

U.S. Bureau of Labor Statistics (BLS), U.S. Department of Treasury 1990 to date



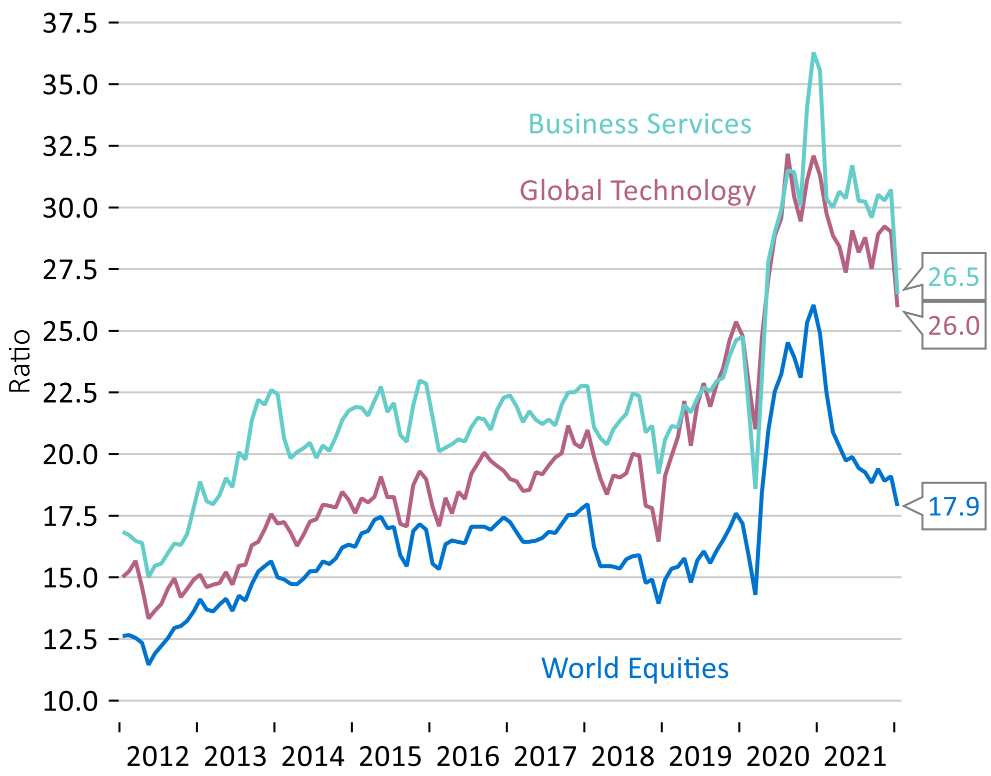
Source: Macrobond, 17.02.22

Risk 2: Excessive valuations

As policy rates normalise COVID-led PE multiple expansion is already starting to reverse

Global valuations are vulnerable as policy normalises

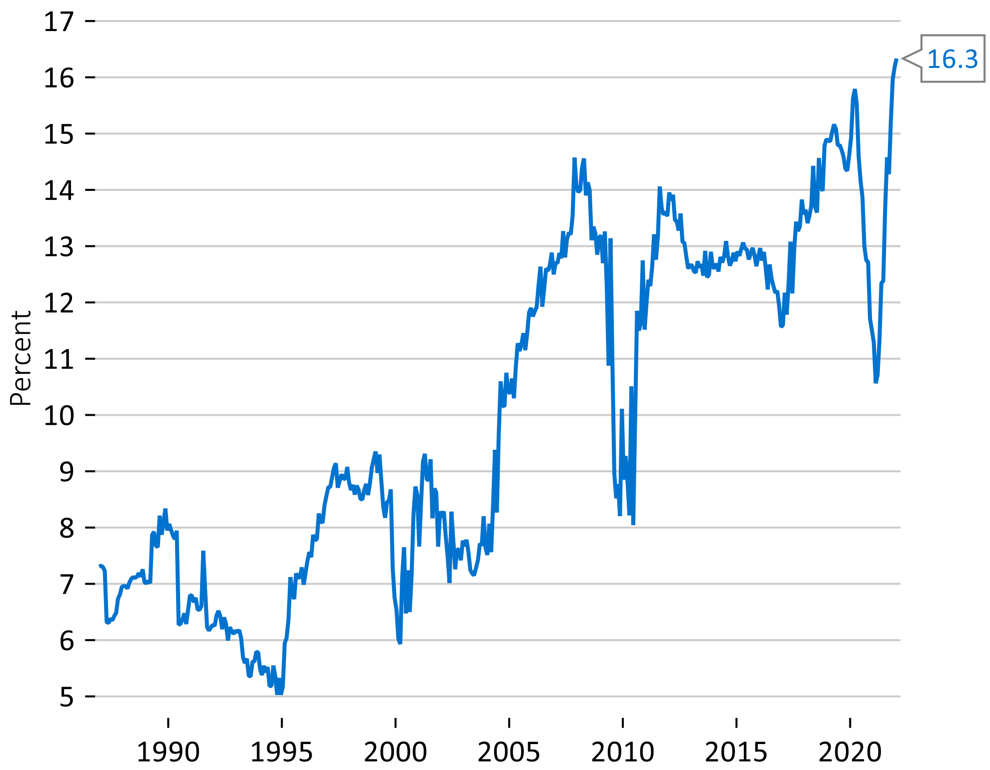
Equity Indices 1 year forward PE (Factset)



Source: Macrobond, 17.02.22

Profit margins are already at record levels

Net Margins for World Equities (FactSet)



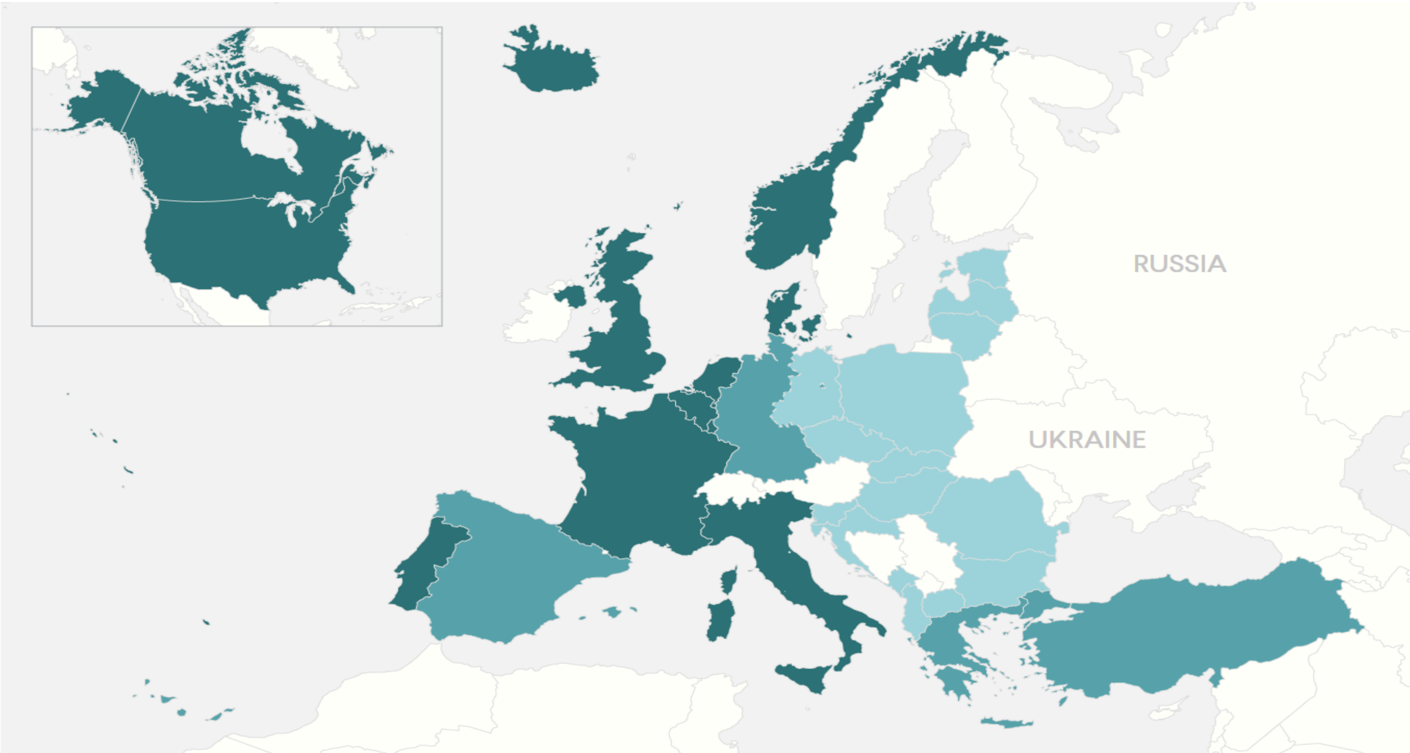
Source: Macrobond, 17.02.22

3. Ukraine: a prolonged stand-off risks higher energy prices for longer

Russian leaders have watched with mounting resentment as NATO has nearly doubled its membership since the end of the Cold War.

Markets are vulnerable to Russian aggression given tightness of gas and oil markets

NATO's Expanding Membership



Founding members | Cold War expansion | Post–Cold War expansion

NATO

Post–Cold War expansion

1990	Germany*
1999	Czech Republic Hungary Poland
2004	Bulgaria Estonia Latvia Lithuania Romania Slovakia Slovenia
2009	Albania Croatia
2017	Montenegro
2020	North Macedonia

Source: Council on Foreign Relations, January 2021

Outlook: As central banks pivot to fight inflation the outlook for risk assets becomes more challenging

Global strategy update – February 2022

Bonds	Strong underweight • Strong UW government bonds – global inflationary pressures remain elevated • UW investment grade credit – yield spreads too narrow – UK charity & infrastructure issues offer social impact benefits
Equities	Neutral • Global neutral – earnings remain robust but central bank liquidity support fading • UK neutral - dividend support and valuation attractive – M&A likely • EM neutral - policy tightening and virus risks still acute – political risk on the rise
Alternatives	Strong Overweight • OW other alternatives– infrastructure and renewables beneficiaries of fiscal spend – liquidity issues remain • OW uncorrelated alternatives – gold positions as hedge against central bank policy error
Cash	Strong Overweight • No currency preference • Consider portfolio insurance
Risks	Current: Valuations stretched, bond market risk as policy tightens, inflation becomes entrenched in labour market Longer-term: Central bank policy error, China/Taiwan & Russia/Ukraine tensions, real bond yields normalise aggressively, climate transition risks

Important information

If you are a private investor, you should not act or rely on this document but should contact your professional advisor.

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