Inflation remains the dominant capital market topic

In the coming weeks, the same themes as during the past few weeks will likely dominate the capital market landscape. They can be summarized by the following set of questions:

How will inflation develop and how and when will the individual central banks react (tapering, interest rate hikes)?
Of course, these themes will depend on a range of sub-topics dominated by buzzwords such as economic recovery, supply chain delays, commodity prices and trajectory of the coronavirus pandemic. There has hardly been a time when assessment of the central banks' actions has been as mixed in the market as right now. For months, inflation and inflation expectations have been the subject of heated and controversial debate. On one hand, we see strong economic growth across the globe, widespread and at times severe supply chain disruptions, rising commodity prices, and wage demands supported by labor shortages. On the other are the central banks (among others), interpreting the current surge in inflation as temporary and warning of slowing growth. Also unusual for market participants: both the US Fed and the ECB have adjusted their strategies in recent months. They accept above-target inflation without intervening immediately. Inflation rates above three percent are also expected for the first quarter of 2022 due to ongoing supply chain issues.

In this mixed situation, any action and reaction by acting central bankers is often interpreted in different ways, and market participants are waiting eagerly during each new central bank meeting to finally hear about a path for the next course of action. Once again, all eyes are on the next Fed meeting (November 3) in the hope of getting clarity. The most widely held view is that this time the US Fed will announce initial steps to taper asset purchases with implementation as early as this year. We must however remain cautious, as similar expectations for the June and September meetings met with disappointment.

For the time being, the ECB is unlikely to take action before the US Fed and will also announce measures on a smaller scale, if any, in response to slower recovery in Europe. Only the Bank of England could be forced to act sooner due to the special circumstances in the UK (Brexit/labor shortage in many areas, energy prices), although we must not forget that this central bank already offered even more support than the US Fed or the ECB last year due to Brexit.

Of course, there are other issues that impact market development, among them the negotiations to form a government in Germany, the emerging energy shortage due to increases in commodity prices as a result of stronger demand and a decrease in investment activity. Other factors to continue to take into account are intensified interventions by the Chinese government in individual sectors of the economy in recent weeks and its impact on economic development, as well as–and most importantly–the trajectory of the COVID-19 pandemic and possible related restrictions. The bottom line is that all of these issues, if they don't escalate, will be overshadowed by central bank policy.

In this environment, we at Kathrein expect the stock market to continue to be well supported for the time being, although volatility will be somewhat higher as changing expectations are reflected in price movements. We must bear in mind that a ten percent correction has not happened in a long time and is therefore becoming more likely. Unless and until enough indicators turn negative, we will maintain our overweight. As for central banks, earlier and stronger reaction could come especially from the US Fed, translating to more tapering but also higher than expected rate hikes. European yields, with ten-year German government bonds as the benchmark, have risen again in recent weeks (currently -0.20%) and, in this scenario, certainly have potential for further increases. With the Federal Reserve moving ahead, the US dollar will be supported and will be able to build on its strength from recent days against the euro.

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