Perspectives

3rd quarter 2022

Inflation – big challenge

IHAG PRIVATBANK

Experience preserves values

Dear investor

In Thomas Mann's Nobel prize-winning novel "Buddenbrooks", the highly respected and well-heeled Buddenbrooks family – by then in their fourth generation – face social and economic ruin. The fact that such developments often involve the fourth generation is no coincidence and can be seen as a sign that this generation lacks the necessary experience due to the absence of a direct link with the founding generation.

Many investors in today's bond market likewise find themselves facing a similar lack of experience. After a 40-year tailwind of generally falling interest rates as well as extremely expansionary monetary policy since the 2008 financial crisis, the current losses in the bond market are not just historic but a completely new phenomenon for the vast majority of investors. As the fourth generation, so to speak, most of them have not experienced the sustained rise in interest rates seen in the 1960s, 70s and early 80s; consequently, the requisite wealth of experience is simply not there. It's a similar picture when it comes to the inflation situation: Current inflation numbers for the US, for example, are the highest since 1981.

The topic of inflation has hit investment markets with full force and constitutes a completely new and unfamiliar situation for the vast majority of investors: Interest rates are rising, while prices of shares and bonds are falling.

The main cause of this situation can be found in the current inflation trend: Rising inflation figures are forcing central banks to adopt a more restrictive monetary policy – and interest rates are starting to climb across the board. While rising interest rates are leading directly to lower prices for investments, the expected cooling of macroeconomic activity due to the tightening of monetary policy is resulting in lower valuations.

Below we take a look at the current market situation. In addition, we answer a few basic questions on inflation and the related consequences and issues before setting out our assessment for the period ahead.

Incidentally, Otto von Bismarck neatly encapsulated the development frequently seen over the generations: "The first generation earns the money, the second manages the wealth, the third studies history of art, and the fourth degenerates completely."

We hope you enjoy reading this publication.

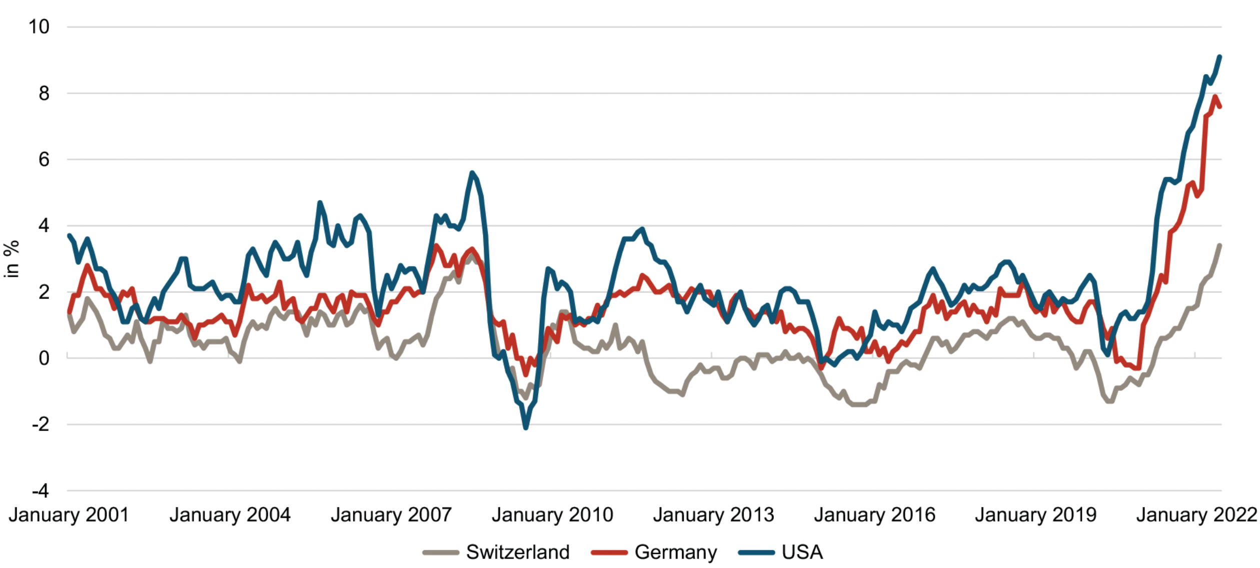
Christoph Boner
Chief Investment Officer

The current market situation is challenging.

Rates of inflation in all major currency zones have been trending sharply upward since mid-2021. In the course of this increase, interest rates have also been rising across the board for months. Higher interest rates for longer maturities are also driven by rising inflation expectations, with the rate increase at the short end of the curve mainly down to the hikes in key interest rates on the part of various central banks.

For example, following the first rate move by the Swiss National Bank (SNB) since 2007, the Swiss yield curve for maturities of two years or more is at long last back in positive territory. With the abandonment of the minimum exchange rate in January 2015, the key interest rate was reduced to a record low of -0.75%. Following the first (double) hike, this rate now stands at -0.25%.

Inflation development



3.40%

Switzerland's current inflation rate

October 1993

The last time inflation was at 3.4%

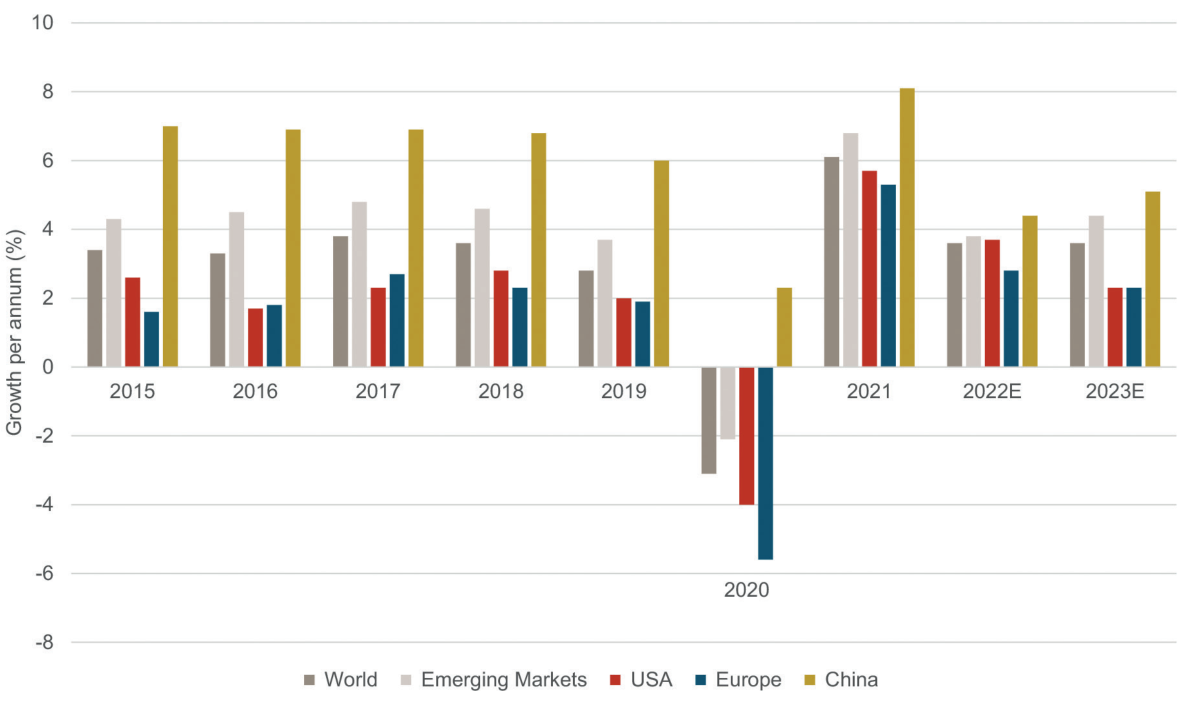
The US Federal Reserve made its first rate move in March 2022 and has lifted key interest rates from 0% to 1.5% in a further two stages. The Fed's more rapid pace is down to the robust economic situation, elevated inflationary pressures and more aggressive monetary easing in the US in the past.

The European Central Bank (ECB) is lagging behind at the moment – in the Eurozone, too, the rate of inflation is significantly above the 2% target figure deemed compatible with price stability. The familiar challenge for the ECB lies in the heterogeneous nature of the European economy: A rate hike will immediately put pressure on credit spreads for more heavily indebted countries and make refinancing more costly.

Meanwhile, inflation expectations are persistently high – if no longer climbing. At the same time, markets are expecting a continued, systematic approach from central banks in their efforts to get inflation rates under control.

With the rise in interest rates across the board, prices of equities and other investments have come under strong pressure in recent weeks – with higher interest rates inevitably resulting in lower prices, as future income is more heavily discounted. Second, increased risk aversion – mainly due to escalation in the Russia-Ukraine conflict – has put pressure on higher-risk investments such as equities. The key question remains: To what extent do rising interest rates – via a slowdown in economic growth – lead to lower asset prices on a sustained basis? In fact, global growth forecasts have been downgraded by a significant one to two percentage points in recent months. Due primarily to continued pent-up demand following the Covid pandemic, however, growth expectations remain in positive territory and there are no indications that the world economy will slide into a sustained recession.

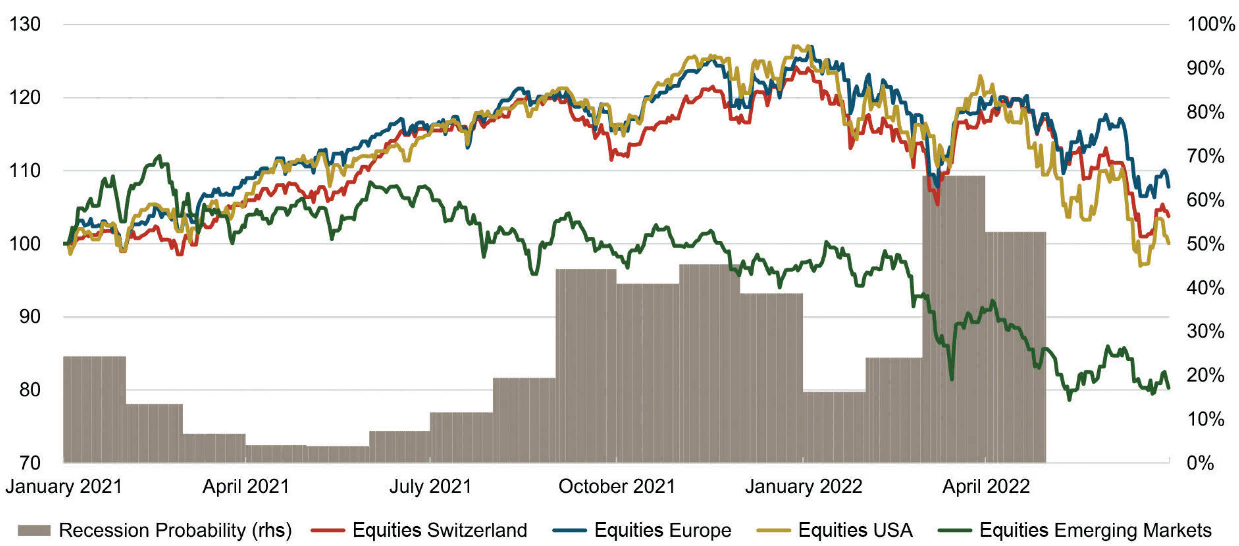
Economic growth (GDP)



Despite the current difficulties, we expect an easing of the situation on markets.

The inflation situation and resulting hikes in interest rates will inevitably culminate in a slowdown in global economic growth. The key question is the extent to which a hard landing – a lasting recession – can be prevented. The likelihood of recession has grown significantly, as reflected in a sharp fall in equity values in recent weeks. Furthermore, given the record level of overall debt in the world's economy, a significantly greater vulnerability can be seen in the rise in interest rates, which is continuing to stoke fears of recession. A slowdown in the economy as a whole could culminate in a credit crisis more quickly than expected.

Probability of recession and equities



Given current already negative narratives and their connotations, there are various reasons to suggest that this risk of a lasting market downturn is exaggerated and that a recovery may well be on the cards in the second half of the year.

Need to anchor inflation expectations

In their attempt to contain high inflation rates, central banks are currently aiming to control inflation expectations – mainly in order to avert the occurrence of lasting second-round effects (such as a rising wage spiral). As well as substantial rate hikes, verbal statements issued by central banks show clearly that the impact of current monetary policy on the economic situation is only a secondary factor in their considerations right now. When inflation eases, they will turn their attention back to the overall economic situation.

Composition of factors driving inflation

Inflation traditionally arises due to an overheating economy in the form of a demand overhang. The current high level of inflation, however, is heavily driven by supply-side factors: Higher energy costs, the fallout from the Covid lockdown, supply chain problems and increasing barriers to trade – not least due to the sanctions imposed on Russia – are fuelling inflationary pressures. This means monetary policy needs to be more effective at lowering the rate of inflation to a sufficient extent. However, the assumption is that adjustment effects on the supply side – companies will adapt to this changing situation – will help reduce inflationary pressures. A corresponding easing in terms of monetary policy as well as the development of interest rates and credit spreads would be the direct consequence.

Acceptance of slightly higher rate of inflation

Although central banks are currently flexing their muscles, as explained earlier, the assumption is that a slightly higher rate of inflation will be accepted over the medium term in the interests of preventing a lasting recession or even a credit crisis. While the battle against inflation is currently accorded top priority, it is assumed that going forward, the focus will shift to preventing a protracted recession – and this will come at the expense of persistently higher inflation rates. Real interest rates will remain negative for the foreseeable future.

"The currently required control of inflation expectations, the mix of inflation-fuelling factors and the medium-term acceptance of a slightly higher inflation rate point to a market recovery in the second half of the year."

Following a first-half of 2022 that brought new – and exceptionally negative – experiences for bond investors in particular, we are cautiously optimistic about the second half of the year. Further developments in the Russia-Ukraine conflict and any resurgence of the Covid situation remain risk factors.

Even so, just a brightening of the general malaise and easing of the current elevated level of risk aversion among investors would be likely to reduce tensions on markets.

Questions and answers on the topic of inflation

Christoph Boner
Chief Investment Officer

What is inflation?
Inflation prevails when prices rise within an economy without any change in the quality of the product or service. The inflation rate reflects the degree of increase in the price of a basket of representative goods and services for everyday consumption. This figure is usually shown as a percentage increase over the past 12 months. The figure currently stands at around 3.4% for Switzerland, 7.6% for Germany and 9.1% for the US.

How does inflation arise?
Inflation arises when the supply of money in an economy grows at a faster rate than the economy itself. This causes a shift in the relationship, and the same volume of goods and services is accompanied by relatively greater money supply, causing prices to rise.

Why is inflation dangerous?
Price stability is a key prerequisite for an economy. All economic actors base their plans on the expected economic situation; if there is no price stability, these plans become significantly more difficult and the ability of the economic actors to adapt is reduced.

How is inflation prevented and price stability safeguarded?
The primary role of central banks is to ensure price stability. By controlling the money supply, they ensure a harmonious relationship between money supply and economic output, meaning prices remain stable. If prices increase, and therefore jeopardise price stability, central banks withdraw money from the system by raising interest rates and restore equilibrium between money supply and economic output. Their job is made more difficult by the fact that central banks do not control the money supply directly and can only control the price of money indirectly by managing interest rates; second, this indirect mechanism is also subject to a time lag of several months.

Why is price stability not defined as an inflation rate of 0%?
The inflation targets of central banks are not usually 0% – which would constitute price stability in mathematical terms – and are instead around 2%. Owing to the uncertainty involved in managing the inflation rate, the specification of a target of 0% would harbour a significant risk of the effective inflation rate falling to below 0%. In such a deflationary environment, there would be a risk of consumer spending – the key component of demand – being postponed at a stroke in anticipation of a further fall in prices. To avoid such a scenario, price stability – and therefore the target figure for central banks – is defined based on values of above 0%. In Europe in particular, the debate has in recent years been dominated by fears that inflation could turn out too low.

Why did inflation fall in recent years despite expansionary central bank policy, and why is it now increasing at a seemingly sharp rate?
Central banks have adopted an expansionary monetary policy since the 2008 financial crisis. While this was initially aimed at providing the financial system with sufficient liquidity to avert a collapse, an expansionary stance continued to be taken during the euro crisis right up until 2020, when the aim was to counter the negative impacts of the Covid lockdown situation. Despite this disproportionate expansion of the money supply, there was no sign of any inflationary trends emerging in the consumer sector. This was thanks to low energy costs as well as sustained efficiency gains on the back of globalisation and the increasing use of technology, which helped counter the upward pressure on prices. The fact that these effects are not lasting is evidenced right now by shattered supply chains and rising input prices, which in combination with the flood of money recently unleashed during the Covid crisis have now led to a sudden surge in inflation.

What can be expected on the inflation front in the next few years?
Inflation will remain at an elevated level over the next few years. In the shorter term, central banks will be willing to accept slightly higher inflation given their focus on seeking to avoid a hard landing for the economy if possible. Longer-term, structural factors in the form of demographic developments, demand pressures due to a sharply increased investment budget for security matters, plus spending in connection with moves to build a more sustainable economy, will result in structurally higher inflation rates. Real interest rates will probably remain negative for years to come.

> "By controlling the money supply, central banks ensure a harmonious relationship between money supply and economic output, meaning prices remain stable."

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