## The war in Ukraine and high inflation rates as the big surprise of the 1st quarter of 2022

### The post-pandemic "take-off" in conflict with the "cost of living crisis" and rising rate

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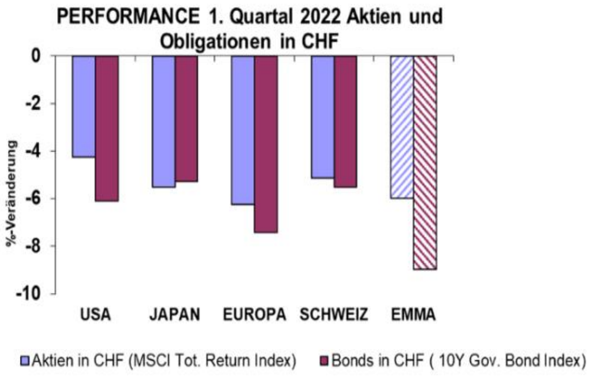
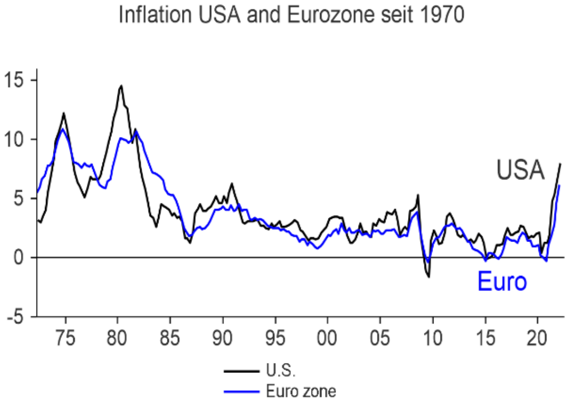
The entry of Russian troops into Ukraine shocked the world. This scenario was only considered unlikely by capital market participants, as reflected in market prices. The reaction was thus correspondingly great. For the first time in a long while, stocks and bonds together suffered marked losses.

The war led to a massive, united reaction by the West. With arms deliveries to Ukraine and sanctions against Russia's oligarchic system. Uncertainty over the further course of the war has led to a marked increase in energy and raw materials prices. This is added to by supply chain interruptions as workers are absent because of the pandemic. The result of these shortages of supply is inflation figures that we have not seen for half a century.





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For further consideration, we assume in the basic scenario of the Ukraine war that energy markets will not see relief this year. Because even if a peace agreement is reached soon, it cannot be assumed that Western sanctions will change, as the European states have already decided to wean themselves off Russian gas and oil so that they can no longer be blackmailed in future. This extensive transformation will be yet more costly for the West as Russian gas will be absent from global markets for a longer period. The development of alternative distribution channels needs time and capital. The energy sector could thus remain under stress until at least the end of the year.

Macroeconomically, this fact is of some import. A one-year increase in the oil price by $10 a barrel alone leads to an increase in the global energy bill of around $320 billion. With gas, a 10% increase leads to prices going up by a similar order of magnitude. We are moving in the range here of one percent of global GDP. Most of this flows from East-Asian and European consumers to the relatively few producers in the Middle East, Russia and other emerging markets. This significant transfer of wealth has three consequences:

1. The well-off producers have a markedly higher savings rate than the consumers paying them, leading to global demand falling. We are assuming global growth to fall by around 1%. In addition, a typical "petrodollar recycling problem" arises, as was seen in the seventies. This oversupply of capital will increase the tendency towards negative real returns on bonds.

2. The massive transfer of wealth means a painful loss of purchasing power on the part of consumers. Politically, this phenomenon has caught attention as the "cost of living crisis". This term also expresses the fact that, in the future, we will not automatically be able to expect inflation to be balanced out via the labour market. As this is cost-push inflation – as opposed to demand-pull inflation – companies do not have any means to finance such an equilibration. Furthermore, the employment market is very fragmented, with wage negotiations now taking place in a decentralised way at the level of companies. We thus consider a wage-price spiral to be very unlikely. Instead, we assume that most companies will manage to roll over the higher costs and the transfer of wealth will be primarily paid for by consumers.

In the USA, in consequence of this development, the high savings rate achieved during the pandemic has already fallen markedly. In terms of economic policy, this means that the States will have to rely ever further on federal aid to avoid social unrest.

3. Monetary policy has little wiggle-room in supply-side inflation as a marked increase in interest rates would once again reduce demand. Loss of purchasing power would then be added to by unemployment. In addition, the problem of supply chain interruptions and shortages would not be solved. We thus do not assume the American Federal Reserve will increase the short-term rates from today's 0.5% above 2% by the end of the year, as has already been priced into the markets. As Europe is particularly affected by the reductions in purchasing power, we do not expect the ECB to raise interest rates above zero.

Cost-push inflation is also considered to have the characteristic of not intensifying. By contrast, even a drastic rise in energy prices that no longer goes away will bring the direct inflation rate back down to zero in a year. If prices correct downwards, inflation would even be negative. We thus assume that inflation rates over the coming years will once again markedly reduce. For this reason, we expect only slight and transitory increases in long-term rates, just until inflation rates likely reach their peak in autumn. The USA is a special case here, as consumers' recovery after the pandemic still has room to grow. The government's recovery programmes are also still having their effect, as can be seen in various economic indicators. Production is also largely at capacity. Here, the effects of the more restrictive monetary policy could be seen, as the supply-side part of inflation is markedly higher than in the other G7 states.

Our analysis also shows that phases of FED interest rate increases tend to give positive returns on stocks, an average of +8% in the last 25 years. Only if the Federal Reserve steers towards an inverted interest rate curve (short-term rates over long-term rates) would the economy tip into recession and stocks develop negatively. We do not expect such overreach in monetary policy, however, even if the pressure exerted by the President on the FED is very great on account of the mid-term elections.

Overall, from a macroeconomic point of view, the long-term picture of the markets is mixed – despite the negative geopolitical surprises of the last quarter – and we believe that the long-term development of risky securities will be positive. Because of the existing global insecurity, however, increased volatility is to be expected – with fluctuations downward not excluded. For this reason, we advise selective additions to the portfolio during future corrective phases and slightly increased engagement in high-quality companies.

This is as much as can be said regarding general trends. And they, after all, are decisive for the end result.

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