Inflation achieves values not seen since the 70s

For stocks, this period was thought of as a lost decade

The fear is that this could repeat itself

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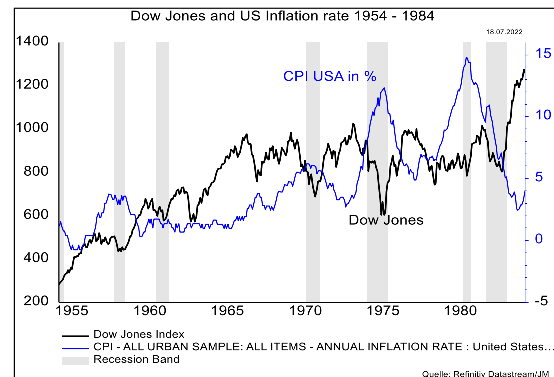
There are indubitable similarities between the 1970s and today. Back then, oil prices tripled at the start of 1974 and doubled again by the start of the 80s. Prices of foodstuffs also rose strongly and the labour market came under strain as the decade began. Consequently, strong inflationary pressure arose, leading by way of institutionalised labour disputes to a wage-price spiral which, in turn, led to monetary braking manoeuvres being initiated, practically always ending in recession. The economy stagnated and, for years, stocks only brought in minimal returns (see Fig. USA).



Despite these similarities, we should not see this period as a model for our own current situation, as there are certain key differences:

- The rise in oil prices over the last quarters was markedly lower than in the 1970s.
- The energy intensity of GDP has in effect halved over the past decades.
- Today's labour market has changed fundamentally since the 1970s. Nowadays, it is much more differentiated, with division of labour and specialisation leading to great heterogeneity in job profiles.
- Furthermore, wage negotiations have become increasingly decentralised over the last 40 years. In most countries, they have been moved to corporate or even individual level.
- In addition, the degree of employee organisation has been markedly reduced. In the USA, in the private sector, only around 10% of the workforce remains unionised.

These conditions make it appear unlikely that a similar wage-price spiral could form in the present environment.

However, this does not solve the problem of the cost of living crisis. The loss of purchasing power felt by individuals is higher than ever: for the current cycle, we are reckoning with a decline of around 20% globally and 10% in Switzerland and Japan. This will certainly cause a precarious situation for many income earners, particularly in the lower income bands. Earlier, the problem was largely solved via the indexing of income streams; in the current environment, however, this approach only has limited scope for implementation. Companies will argue, justifiably, that they are not the beneficiaries of the higher prices. In the case of energy, it is suppliers, particularly those in the OPEC states, that profit from the large-scale redistribution of income. Who should therefore pay the price for citizens' loss of purchasing power? As energy-based inflation is related to a supply shock caused by war and the pandemic, a political decision will need to be taken to distribute the burden of this external shock fairly. Most likely, the principle of tax fairness will be applied. Concretely, what this means is that the state will provide funds financed on the basis of progressive taxation. If the state does nothing, the price increases work like a regressive tax: those on low incomes bear a heavier burden than the upper income bands. For this reason, the OECD has emphasised the need for Member States to institute unbureaucratic, time-limited direct payments to vulnerable population groups. Most Western countries have, over recent months, agreed on such aid packages. These both take some of the pressure off wage negotiations in August and simultaneously prevent one-off price increases being permanently built into wages.

A differentiated picture can be seen where operations have had to reduce their production because of a lack of components (e.g. chips). These companies may have had to reduce quantity in many cases, but their revenues have nevertheless increased as they were able to sell their scarce products to the highest bidders. In this way most car companies, for example, have been able to post record profits for the past year. In these cases, employers then have greater leeway to raise wages.

In many countries, however, there exists only slight difference between headline inflation and core inflation. This indicates that yet other factors are driving inflation. In the USA this difference is particularly low (less than a third) and it is above all private consumption that has shot up. More than half of what was saved during the pandemic has been spent in the last 12 months. This development, together with the large-scale pandemic programmes, has caused the overloading of the means of production and further intensified the general increase in prices. For this reason, it is not surprising that American companies posted glowing profits for the last year. For American companies, therefore, there is scope to guarantee wage increases; however, this will only happen if the good economic situation remains in place. At the moment, this is far from certain.

For sure, however, the Federal Reserve is facing a challenge! With its turnaround towards restrictive monetary policy, it wants to ensure that no inflationary expectations arise. Whether it is able to execute the striking rate announcements to the full extent remains an open question. Because, in the mean time, the boom has cooled off tangibly: half the savings built up during the pandemic have already been exhausted, and citizens' purchasing power has dropped massively. The Federal Reserve wants to wait to reassess its policy until there is certainty that the breakout inflation, which began in summer 2021, is once again subsiding.

Anyone insisting on comparing the current situation with the 70s would judge the inflationary process critically. Overall, however, and as stated, we consider this comparison scarcely meaningful. The institutional and structural conditions of today are such that we hardly need reckon with significant second-round effects. At least a portion of the increase in prices will need to be borne by employees themselves. In any case, we assume that the cushioning of the effects of the energy price increases – at least for the lower income bands – will be able to be compensated for through financial policy. For this reason, we deem the threat of a longer-running wage-price spiral to be low.

If the situation does arise, however, that Russia turns off the gas taps, we would have to assume a further increase in inflation by one to two per cent, as all energy media would once again rise in price. But even in these cases, we assume that rerouting energy flows will largely be completed during the next four quarters. Then, energy prices would once again normalise. As even a constantly high energy price would let inflation rates drop over time (the base effect), there is reasonable hope that a relaxation of inflationary pressures could be expected over the next year from this sector.

So far, we have barely touched on the central banks. And rightly so, it seems, as far too much is being expected of them. They are being scolded above all by those who have claimed for decades that if you stretch the amount of money printed you will have to deal with inflation sooner or later. They now feel confirmed in their views and authorised to shout their solution from the rooftops: demanding that the banks' policy return to the simple principles of monetarism. It is an approach that has proved little help over recent decades, however. Certainly, money needs a price once again – at least in places where supply and demand shocks have come into effect. This applies to a marked extent in the USA, where the consumer boom in the post-pandemic phase has taken on unusual dimensions. But even in the USA there is a high likelihood of excessive consumption soon reaching its limits, as it was largely based on the reduction of savings built up over the pandemic. The loss of purchasing power could make itself more keenly felt, as we assume that it can only partly be made up for by wage increases. Through high inflation, a considerable portion of the assets held in nominal values has been transferred to debtors. This will also contribute to damping consumption, as debtors tend to have a lower level of consumption than creditors. There are thus strong forces in the economy acting to normalise consumption. Nevertheless, the central banks play an important role. By announcing that they will raise the price of money step by step, they indicate that they are not prepared to allow inflationary expectations to emerge. Looking at the upcoming wage negotiations, this is not an insignificant course of action. How far they will have to raise rates is an open question here, as they have only very limited leeway, this due to the fact that global savings remain larger than investments, which has barely changed. For this reason, the long-term real interest rate could barely lie above one per cent (USA) or zero (Europe). A FED Funds Rate of over 3 per cent, as already priced into the US markets, will already be restrictive in its effect if the Fed is striving for an inflation rate of two per cent. In Europe, the corresponding value is two per cent. This only applies as long as the attempt to keep long-term inflationary expectations under control is successful; the most important indicator for this is the long-term capital market rate.

Those who join many commentators in hoping that the old rate will soon celebrate its comeback could well be disabused of their notion.

In the last forty years, we have only seen one trend in inflation and interest rates: downwards. This brought us unparalleled valuations for almost all assets. No doubt: a change in the trend would require massive corrections in valuations. But the pandemic- and war-related inflationary shock is transitory in nature. It indicates a dynamic with strongly centripetal forces that makes it seem likely that inflation will drop back gradually to its 2-per cent level. The prerequisite for this, in any case, is that the central banks act cautiously. An over-restrictive rate in an economic environment marked by decreasing growth rates would soon end in a severe recession. Loss of purchasing power would then be added to by unemployment. A mixture that, in many places, would be hard to get on top of politically without consequences. It would thus make sense for central banks not to act over-hastily, but to give the inflationary cycle time to stabilise. The focus, here, is rightly on stabilising inflationary expectations, leaving no doubt that the defined inflation target will be pursued with all due determination.

Overall, we consider the current atmosphere on the markets to be somewhat over-pessimistic. It is marked by the shocks of the last two years, shocks which, however, triggered powerful counterforces in themselves. We can already see that substitution of Russian energy supplies is proceeding faster than originally assumed. As soon as it becomes apparent that we are not dealing with centrifugal forces, the mood across all markets will brighten. The high point of inflation has not, however, been reached yet. And the risk of further pandemic developments remains under the surface. In addition, the great loss of purchasing power on the part of workers could trigger some political tension. Great Britain, Italy and Sri Lanka have already had a taste of how quickly political order can be thrown into turmoil.

We thus consider it appropriate to retain, for now, the cautious investment policy of the last six months. However, the risks have shifted to weigh more heavily upon Europe.

This is as much as can be said regarding general trends.

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