Inflation has risen to become the central problem of financial markets and economic policy

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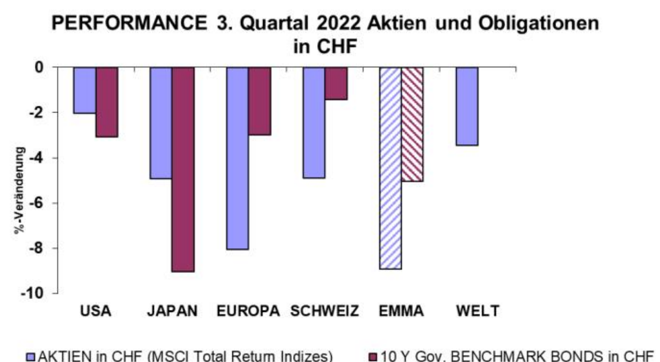
In the summer months, central banks had to prescribe the economy a bitter pill: a seismic shock in monetary policy, shifting from expansion to restriction.

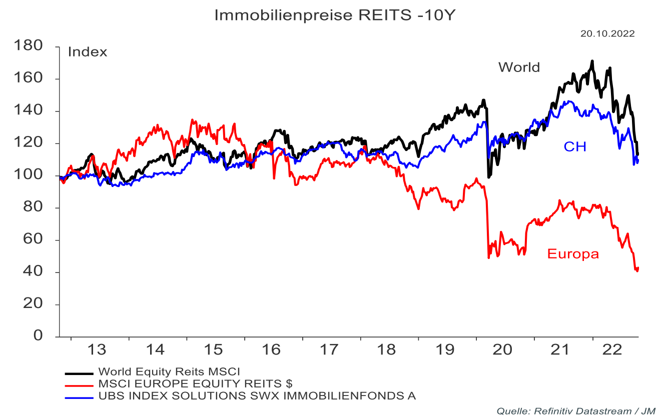
The Brits and Americans have hastened forward most rapidly with this. Already in June, the USA announced significant hikes in Federal Reserve interest rates at rapid intervals. In a few months, the Fed Funds Rate rose from below 1% to 3.25%. On 2 November a further jump of 0.75% might be approved, allowing the rate to surpass 4% by the end of the year. Such a sequence of changes is unheard-of in the last 20 years! Not surprisingly, Jerome Powell has repeatedly stated that he is an admirer of the policy adopted by Paul Volcker, his predecessor from the eighties, seeing him as a model. The latter was prepared to lower inflation at the cost of triggering a sharp recession. But it would be a fatal mistake to compare the current inflation with that of the 1980s. At that time, the determining factors behind endemic inflation were different in nature. Expectations of inflation had embedded themselves deeply within the system. Index mechanisms were included in the toolbox of the political economy. The wage/price spiral was inherent to the system. Thus, in 1981, inflation reached a peak of nearly 20%. At the same time, bondholders were unharmed, with rates above this value. Thus, capital had a real interest rate.

Today, the situation is different. The target of 2% inflation has deep roots and is institutionally grounded. This can be seen in long-term bond yields, which have nominal values far distanced from today's inflation rates. 10-year US treasury yields currently have a rate of under 5%. In Germany, it is below 4%. This is a sign that capital market participants see inflation as transitory. There is no trace of panic here. For Powell, however, it is a different story. He does not trust the financial markets. He is afraid of a potential wage/price spiral, even though a series of studies has shown that the institutional conditions today are far different from those faced by Volcker. However, he does have the support of all those economists and politicians who have been sounding the alarm for a decade now about the large quantity of money being printed by central banks – in contravention of accepted principles.

What is the macroeconomic import of this sharp change of direction in monetary policy? Certainly, the increased interest rates will weaken economic growth further than already expected. The IMF foresees the USA's GDP growth to slow from 5.07% (in 2021) to 1.0% in the next year. Sadly, this contraction will only have minimal influence on the price increases caused both by the pandemic (supply chain problems) and military aggression (sanctions). The same goes for country-specific supply-side limitations (labour, chip shortages). It is a measure which unilaterally limits demand – demand which, because savings have been exhausted and real assets have sunk in value, was already on the decline. In Europe, external factors play an even more consequential role. Pressure on the single market will thus be reflected in a much faster decline in economic fortunes. The USA's aggressive positioning has a negative effect on other market players: based on the expected economic downturn, stocks have fallen sharply. And even bonds are unable to turn a profit. Long-term rates have risen again as the worsening economic situation increases government deficits and debt. Risk premiums have thus also risen further than what was expected from the more rapid reduction in inflation.



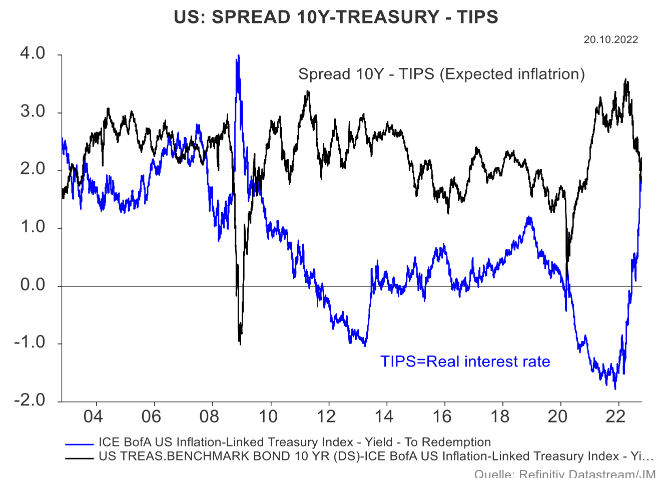
And rate-sensitive real estate has also suffered severely, as fund indexes show.



Naturally, other factors also play a role in the poor performance of the financial markets in the 3rd quarter of 2022. However, the monetary shock is, for us, central. The economic downturn expected by all is already reflected in the market situation. However, there remains the risk of an incorrect calibration of monetary policy. Sticking too long to an interest rate above what is natural would certainly end in recession and induce much greater losses on the stock market. This could put financial stability at significant risk. The British example, where a failed fiscal policy by a new cabinet spooked the markets, clearly showed that latent risks can easily become virulent if imbalances arise on the opaque derivatives markets.

But not exerting enough control over monetary policy is also dangerous. If restrictive policies are loosened too early, expectations of even greater inflation could form, only to be countered later by higher costs. At the moment, we consider this risk less than that of overreach.

All in all, we consider the harsh action of the Federal Reserve as a message to all market participants: do whatever you can to stop inflation taking hold. Considering the facts, we see no need for the FED rate to rise markedly beyond what has been announced. A Fed Fund Rate of 5% would be overkill, in our opinion. This is because the indicators are so clearly set on a global level for a slowdown in the economy, meaning screwing down the lid further would be unnecessary. In addition, the imbalances in real markets have already faded somewhat. Prices fell over recent weeks below their high water marks.



And inflation expectations have also fallen.

For the coming year, they have dropped from around 4% to 2%. At the same time, inflation-protected investments have got more expensive. At the start of the year, holders of inflation-protected bonds received a rate of 1.5% interest; now it is more than 2%. If these signs of easing off are also reflected in real markets, we are justified in hoping that the situation is not as bad as it appears. Despite these possibilities, we must not forget that geopolitical, pandemic- and war-related risks are still weighing on the global economy, as the IMF rightly confirmed in its October forecast.

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

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