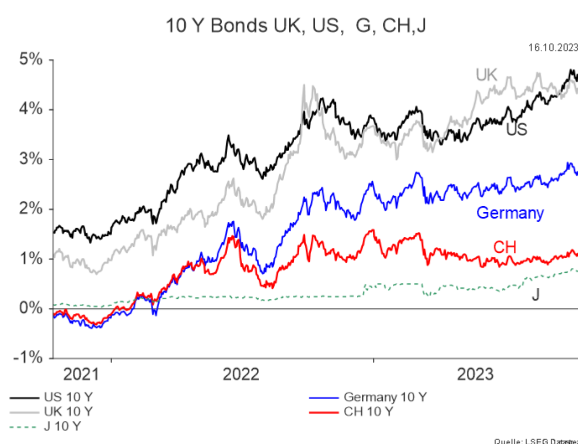
# CORUM investment policy Q4 2023

## The profit cycle as a new challenge for monetary policy

The latest empirical studies in Western countries show ever more convincingly that the extremely high inflation figures over the last two years cannot in the most part be put down to the large-scale external shocks occurring since 2020. They are home-made. Across the globe, we have witnessed an unprecedented increase in company profits. Bivers[1] estimates the profit-related component of inflation in the last two years at 55%. Other studies in Germany, Austria, Canada and Australia show figures of a similar order of magnitude. It will take researchers a long time yet to determine how this came about. The more so since, in all economic cycles, profit margins sink in periods of full employment and rising demand. We can rightly refer to this, therefore, as "profit-price inflation".
We are now in a wholly new starting position. Concretely, these novel circumstances mean that around half the price increases will be borne in the economy. They will fall to companies or shareholders. These players are well equipped to deal with the next phase. However, employees lack such means of support. They have to bear not only the costs of the pandemic, disrupted supply chains and war in Ukraine, but also the transfer of income from wages to capital. The loss of wealth for this group is thus significant. Not for no reason has the "cost of living crisis" become a ubiquitous term, particularly in the Anglo-American sphere.

Those responsible for monetary policy also see themselves forced to reassess the situation. Powell, and subsequently Lagarde, justified their never-before-seen interest rate hikes based on the fear that price increases caused by real-world shocks could lead to a wage-price spiral, allowing costs to be driven yet higher the longer it took for a rigorous monetary policy to be put in place. In rapidity and magnitude, the interest rises that followed were without precedent. However, no trace of a wage-price spiral has materialised. On the contrary: weak nominal wage growth has helped to tamp down inflation.

The danger lurks elsewhere. We must assume that companies will try to exploit the high profit margins of their products for as long as possible. They usually achieve this by increasing production capacity. To this end, new employees need to be added to the workforce. This is particularly the case in the USA, where – despite sharply rising interest rates – demand for labour has been far above average for months. This dynamic growth process could continue well into next year and overcompensate for the moderating effect of interest rates and the lower purchasing power of most wage-earners. As a consequence, US long-term interest rates have risen to their high-water-mark in this cycle. This also applies in Germany. Only in Switzerland is it not the case, as the central bank has also had recourse to monetary policy in shaping its reaction.




[1] Bivens, Josh (2023): What profit-price spirals are telling us about postpandemic inflation, Intereconomics, ISSN 1613-964X, Sciendo, Warsaw, Vol. 58, Iss. 3, pp.167-168,

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On top of all this comes demand from those people who were able to improve their financial status through inflation during the years of crisis, whether by way of increased profits or a reduction in real terms debt. Fundamentally, this adjustment process should be assessed positively. On the one hand, it helps excessive profit margins get back to normal levels, as expanding volumes put pressure on prices and labour costs increase. Lower prices in turn contribute to further reduction in domestic inflation, while higher wages in part correct the loss of purchasing power seen over the past two years. Essentially, this adjustment process seeks to find a new equilibrium. However, this could take some time.

The Federal Reserve could be tempted to make increasing employment its justification for leading the economy into a recession. To achieve this, a marked increase in short-term interest rates above 6% would be necessary. This could finally bring the moderate economic upturn to a decisive halt. Above all, the interest-sensitive parts of the domestic economy would be affected, foremost among them construction and industry. Relatively little would be gained. Domestic inflation would return a few months earlier to around the 2% limit. Against this, there would be high costs in the real sector (unemployment or a growth slump).

We consider this scenario hardly likely, and for another good reason. Markedly higher interest rates would threaten many regional banks. Their large bond portfolios, built up during the pandemic, would lose yet more value and put the banks' capitalisation in danger if customers grew concerned and began to withdraw their deposits. In such a situation, bonds would have to be sold at market rates and losses written off through equity.

We therefore assume that the Federal Reserve will not take short-term interest rates above 6%, and that the inverted yield curve will remain in place far into next year. This has already led to an increase in long-term interest rates. Given this new scenario, we expect a further one-off increase by 25 basis points in the coming months. At that point, the inverted yield curve will have existed for over a year and exerted its full effect on the real sector, economy, unemployment and prices. Then, in any case, nothing more should stand in the way of the interest rate turnaround.
Overall, this reassessment of the inflationary process offers little comfort, as it can no longer be traced back to the shocks incurred over recent years – shocks in whose nature it was to disappear again of their own accord. No: it is the astonishing change in the behaviour of companies that has led to these price shocks, which have been taken far beyond what would have been caused by the external costs. The profit-price spiral has a very different quality to the wage-price spiral seen in the seventies. We must wait to find out how this situation arose and see what economic policy can do to react to it. We have little recourse to previous experience. There is little likelihood of getting through this without a trial-and-error phase. In terms of investment policy, such a phase would certainly be one of increased volatility. This also applies in Europe, which is somewhat less affected than the USA in terms of capacity utilisation, but which remains far off the 2% goal. A neutral position in stocks and bonds is thus the best in the present circumstances.

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

Yours, Prof. Josef Marbacher

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