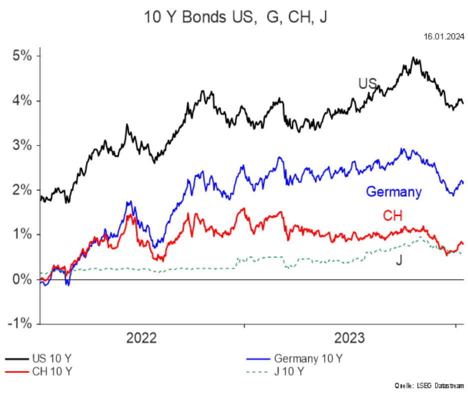
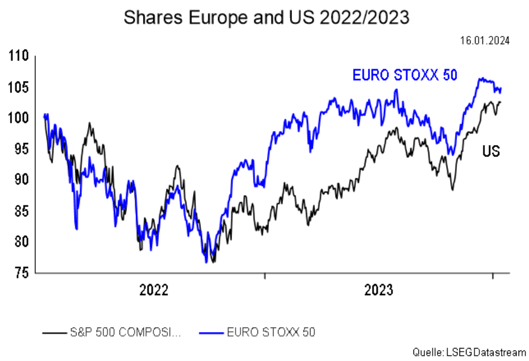
Interest rate turnaround in full force

Initially, it was commentators and the media who were preoccupied with proclaiming the upsurge in interest rates. They urged central banks to combat inflation with all their might. Even a recession would have to be countenanced in striving for this goal. For a decade, western monetary policy, they said, had been too expansionary. The exploding monetary base was their evidence of this. And now look, we can see the results: inflation at levels not seen for decades, and a process very difficult to counteract.

A protracted, costly battle is apparently ahead of us. In September of last year, the Fed declared in its "Forward Guidance" that rates would stay "higher for longer". And now this: the capital markets made short work of this guidance at the end of last year, tossing it overboard as completely unrealistic. Long-term rates have sunk notably across the world and nearly all asset investments, particularly stocks, have gained value.





The question is whether the turnaround will last. Central banks certainly don't want to believe it. They are leaving interest rates at the same high level because they still assume, as before, that inflation can continue to rise. Market participants do not share this worry. There is good reason to believe that capital market participants will once again be proved right.

First of all, central banks have made too many poor predictions over the last three years. Powell justified his change of strategy in March 2022 because of his serious fears of a wage/price spiral. He could only get a handle on this, he claimed, with a monetary policy shock. He expressly referenced, again and again, the example of Paul Volcker, who let the Fed Funds Rate risk to 18% in the early 1980s. Volcker's shock method was then suggested to other central banks. The ECB immediately followed his example. Many commentators and analysts supported this action. Some were even critical that the change in policy had come too late. Other notable experts did not share Powell's analysis of the situation. They pointed out the fact that the high inflation rates were overwhelmingly based on supply shocks (the pandemic, heat-related crop failures, delivery problems, the Ukraine war and energy bottlenecks). Markets with shortages of supply had to be brought into equilibrium through increased prices. It is common knowledge in the field that an activist monetary policy should not be used to tip the scales of such adjustment processes. Milton Friedman already derived this finding in the sixties from experience in the post-war period. The main argument is the delayed effect of monetary policy. As a rule it takes 12 to 28 months for higher interest rates to bite. At such a point, most of the disturbances will be in the past.

And this is something we can now observe: all the above market adjustments have taken place. Only now are the effects of the high interest rates being seen. They will markedly depress growth in the global economy over the coming two years; in some cases, recession will occur. The process is justified by fear that wages will now be able to rise too greatly. So far, only prices and profit margins have seen a rise. Reference is always made, in this regard, to the 1970s.

But such a comparison is misleading. It does not take into account the fact that the wage formation process over the last 40 years has been extensively decentralised from the national level to different economic sectors, then to individual companies and thence to individual employees. This is also shown in the loss of importance of the unions. In the given period, the level of labour organisation has halved on average in the OECD countries, from 33% to 16%. In the private sector, it has fallen on average below 10%. The prerequisites for wage-induced inflation are therefore not in place. On the contrary: for the first time in post-war history, the phrase "cost of living crisis" is on everyone's lips. This expresses the fact that disposable income has fallen in real terms for many employees. In this situation, nobody wants another recession brought about by monetary policy.

A series of more recent scientific papers have thus reached the conclusion that monetary policy should be calibrated differently during demand shocks and supply shocks. In the latter case, neutrality is the watchword. Financial policy is accorded great importance in this.
All these arguments make it seem logical for the central banks to abandon their shock experiments as soon as possible.

This won't happen quickly, however. They will certainly wait again until inflation hits around the 2% mark, in order to say: "Look! We have won the battle against inflation!"

But capital markets don't want to wait around. They have decided: change must come. And they could very well be right, again.

In terms of investment policy, this means we have slightly overweighted all investment categories. This includes real estate, which has suffered, particularly in Europe.

Best wishes,

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