Interest rate turnaround initiated. Critics consider this to be premature. They fear a rebound in inflation

Companies have weathered the major shocks of the last four years brilliantly. If the stock indices are taken as a benchmark, in most cases they have exceeded the levels before the shocks or even reached new highs. Neither the Corona pandemic, nor the war in Ukraine, nor the high inflation rates, nor the monetary shock of the central banks could seriously jeopardize the positive performance of equities. The main contributor to this pleasing result was the fact that many fears expressed in the wake of the major shocks did not come true. For example, the Corona pandemic raised fears that it could exceed the dimensions of the Spanish flu. At that time, around 50 million people died, more than in the First World War. Thanks to research, which provided a vaccine in a very short time and made such a horror scenario a non-event. The supply chain problems triggered by the pandemic and the Ukraine war have also not caused lasting damage to companies, as the shortage of goods has allowed them to increase margins.

However, the misjudgement of those opinion leaders who interpreted the high inflation in 2022 as the beginning of a long inflation cycle set in motion by the coming wage-price spiral has proven to be particularly value-preserving. Historically oriented economists in particular have repeatedly referred to the seventies of the last century with its double-digit inflation rates.

This was followed by the most aggressive rise in interest rates since the Second World War, with considerable value corrections on the financial markets. In the meantime, we know that the scenario of the wage-price spiral has not become reality. In contrast to the 1970s, energy prices have also declined quite quickly for the most part. The new state of affairs is more aptly described with the term "cost-of-living crisis". It has simply been overlooked that the wage formation process has largely been decentralised from the national level to the individual company over the last 30 years. In the same period, the degree of union organisation has also almost halved. In the private sector, it has fallen to below 10% in the OECD.

The inflation shock of the last four years has also been misjudged in terms of determinants. Many attributed it to the expansionary monetary policy of the past decade. It is therefore demand-related. However, the research results of the last two years show that the shortage of supply was a much more important determinant. Goods became scarce due to the pandemic and the war. The price explosion helped to quickly overcome this shortage. Not surprisingly, most prices have fallen back to their starting levels with the normalisation of supply. This has little to do with monetary policy.

It is gratifying that this realisation is becoming more and more prevalent among central banks. Thomas Jordan, Chairman of the Governing Board of the Swiss National Bank SNB, must have been aware of this realisation for some time, as he has participated in various conferences that dealt with the above-mentioned problem. It is therefore not surprising that the SNB initiated the interest rate turnaround as early as March.

However, the new statements from the European Central Bank ECB are surprising, namely those of the head Christine Lagarde, who so far hardly deviated from the aggressive choice of words of Jerome Powell, President of the Federal Reserve Fed, when she states the following:

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"In a typical policy cycle, where volatility is due to moderate and short-lived shocks, inflation expectations are usually not at risk. The price stability mandates and reaction functions of the central banks provide confidence in the inflation target. In typical demand shocks, central banks achieve their goal by stabilising demand within the scope of potential output. And when it comes to supply shocks, central banks can in principle 'look behind', as these shocks usually have no lasting impact on inflation." [1]

These are amazing words. For the first time, Lagarde considers that the current cycle could be supply-side in nature and thus a policy of "looking through" could be considered. Even more astonishingly, Christine Lagarde's paper mentions a research paper by her staff[2] that concludes that the current inflation cycle is dominated by the various supply shocks.[3]
With this striking placement of her research staff, there is justified hope that Lagarde's differences with her staff should be resolved.

In terms of investment policy, this is good news. We can expect a clear distinction to be made between supply- and demand-driven shocks in future outbreaks of inflation. The former challenge central banks in that they should keep calm and refrain from harmful activism. This strategy of "looking through" is not easy to communicate politically. This was shown by the 2022 American midterm elections, where Biden exerted great pressure to "finally do something courageous about the rapid loss of purchasing power".

However, there is no shortage of dangers that could lead to new shocks. The focus is undoubtedly on the failure of the Democratic Party of the United States to replace its candidate for the presidency in time. Currently, the probability that Trump will be in office for a second term is increasing significantly. This would mean that nationalist and isolationist tendencies would have to be expected again. Efforts to slow down China's rise to hegemonic power will also become a topic again. This means more sanctions, less division of labour, less productivity and less prosperity globally. Retaliatory measures by China could lead to significant shocks in supply chains, as China has a strong position in the supply of raw materials (rare earths, etc.).

Dangers also lurk in Europe. The loss of prosperity caused by Brexit, the pandemic, and the Ukraine war have caused unrest among the European population. In the UK, the lack of compensation for inflation through wages has led to a loss of purchasing power, which has driven the population into the arms of the opposition in a rare mass movement.

In terms of investment policy, this does not have to be a disadvantage, as Labour's programme sees the solution to the problems at hand primarily in a growth policy that leads to more tax revenues. This is only possible through cooperation with private companies. They must be granted location conditions that make investments worthwhile. The path to higher debt is blocked, as the debt ratio is above 100% of GDP.

In France, too, the dissatisfaction of the population has led to a large exodus from Macron's center. The fear of the left and right extreme parties has evaporated. Change is the order of the day. The only question is where to go? The Nouveau Front Polulaire NFP, hastily assembled shortly before the elections, has achieved first place in the National Assembly with 182 seats, but is politically anything but homogeneous and far from an absolute majority (289 seats).

[1] Lagarde, Christine (2024), "Monetary policy in an unusual cycle: the risks, der Weg und die Kosten»", paper presented at the ECB Forum on Central Banking, Sintra.
[2] Baribura, M. et al. (2023), "What drives core inflation? The role of Supply shocks", Working Pager Series, No 2875, ECB.
[3] “Overall, supply shocks can explain the bulk of the post-pandemic inflation surge, also for core inflation. Being able to gauge the impact of such shocks is useful for policy making.” Baribura, M. et al. (2023), p.1

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Macron and his centrist alliance "Ensemble" must now enter into a coalition or form a government of experts along the lines of the Draghi government in Italy at the time, while ensuring that the pro-democracy movement does not falter. That could take months. During this time, the French government's ability to act is severely limited, both domestically and internationally. In the longer term, France's debt, which far exceeds the Maastricht criteria, remains an economic policy challenge and a risk factor for the euro area. In this uncertain transitional period, increased investment policy volatility is to be expected.

Overall, there is no shortage of dangers. However, they are more firmly anchored in the social and political sphere, rather than in the investment policy sphere.

However, the dangers are still offset by good opportunities. First and foremost, the prospect of even falling inflation rates, which have long made it seem sensible for monetary policy interest rates to fall to a neutral level. In addition, the American economy has also slowed down and a first interest rate cut by the Fed has already become more likely in September. In addition, the companies still have a comfortable profit situation, which continues to justify the high valuations. Furthermore, it can be increasingly expected that the great productivity potential offered by artificial intelligence will diffuse into more and more industries.

However, there has been more clarity about the outcome of the elections in the United States since the weekend. Joe Biden can no longer prove that he is capable of holding the office of president for another four years. Even within the Democratic Party, pressure is growing to replace him. However, this makes it late, too late, to be able to jeopardize Trump's victory. With the attack at the weekend and the "heroic mastery of the attack", he has also achieved cult status in wide circles. There is hardly anything standing in the way of Trump's second term in office. In terms of societal and social policy, however, the course is set more in the direction of the dismantling of national and international collectives (state, international organizations) and more entrepreneurial freedoms.

If these factors are weighted, the opportunities are likely to slightly outweigh the risks. In particular, the window of falling interest rates that has opened suggests that most investments will continue to develop positively. We therefore think it is appropriate to move equities from neutral to slightly overweight.

Bonds still have a chance to generate temporary capital gains, as we do not see inflation as a persistent phenomenon. In addition, we expect the (real) natural interest rate to still be able to make up ground, although it is unlikely to fall back to the level of the last 10 years. Therefore, the slight overweight of bonds still seems to make sense to us. We take account of the higher political risk by hedging a higher proportion of foreign assets.So much for the big lines.

With warm greetings

Prof. Dr. Josef Marbacher & CORUM Investment Office

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