The impact of inflation on interest rates
The brutal ending of the “low for longer” narrative

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Credit Broker Association
LLN, the 28th of September 2022

Introduction

- **Major concerns**
  (war, purchasing power, environment)
- **Negative returns**
  … including on defensive portfolios
- **Stagflation widely expected**

$\Rightarrow$ **What will happen with interest rates ?**

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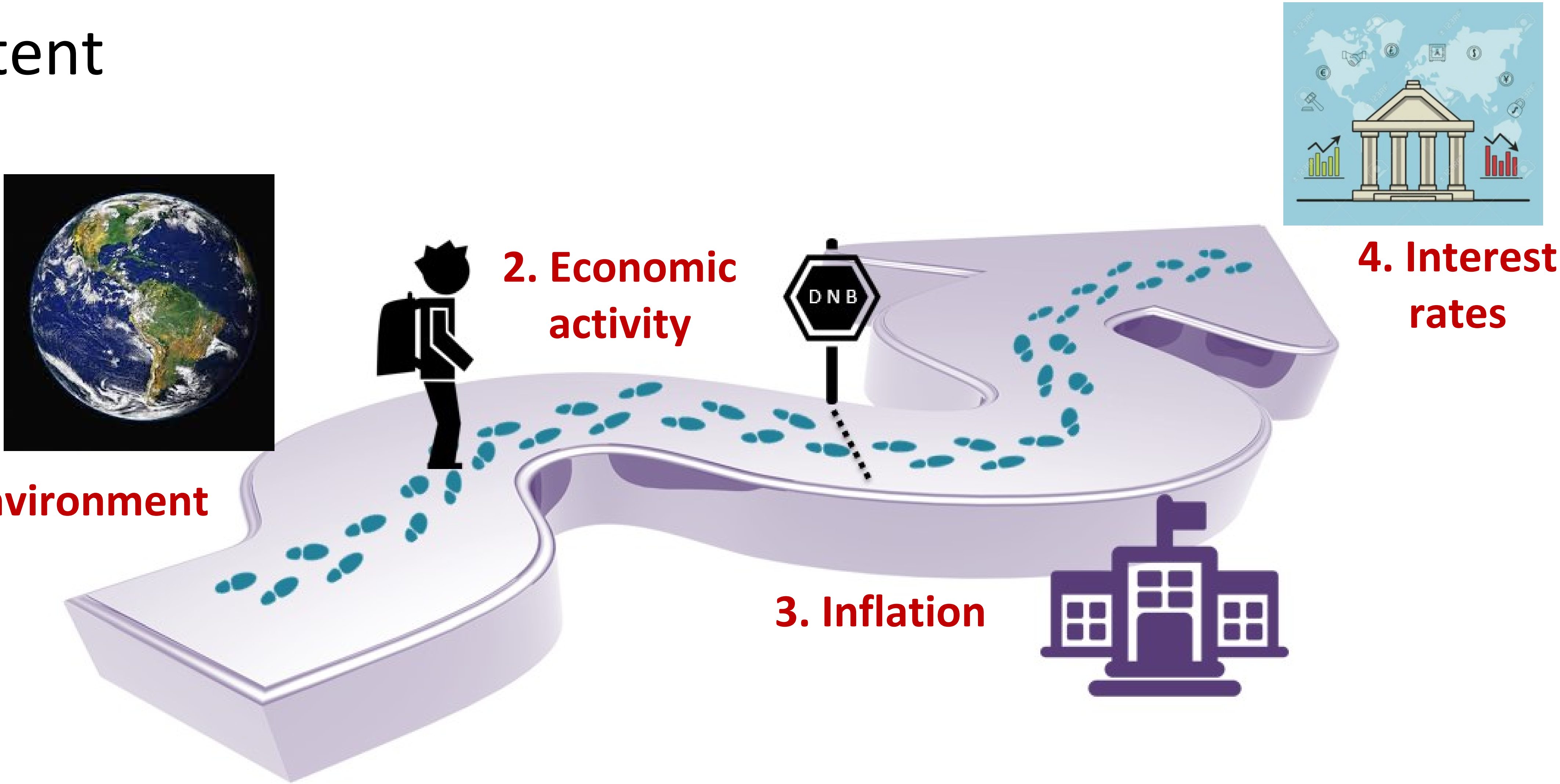
Content


1. Environment
2. Economic activity
DNB
3. Inflation
4. Interest rates

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1. Environment

(1) Pandemics – getting used to it

- Still with us

- Especially in China

- With impact on
    * supply
    * sentiment

- But most likely on the way of receding

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(2) Russia – nobody knows

- No economic rationale => impossible to predict

- Bad news
  - * More uncertainty for longer
  - * Risk of face-saving behavior
  - * Inflation scares

- Other geopolitical tensions

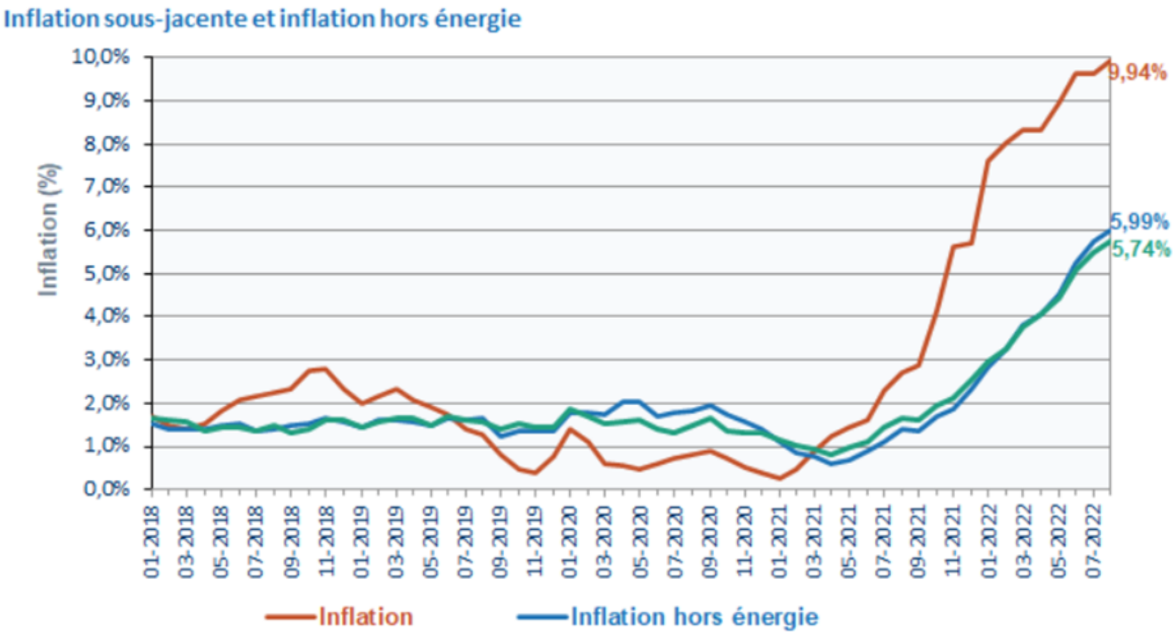
(3) Environment – no place to hide

A common good concern first
… with economic costs now directly perceivable

- Public health costs and expenditure
- Impact on crop yield
- Impact on industrial production
    - Physical constraints (river Rhine)
    - Necessity to curb future emissions
- Impact on labor productivity

(4) Inflation – a long-lasting transitory phenomenon

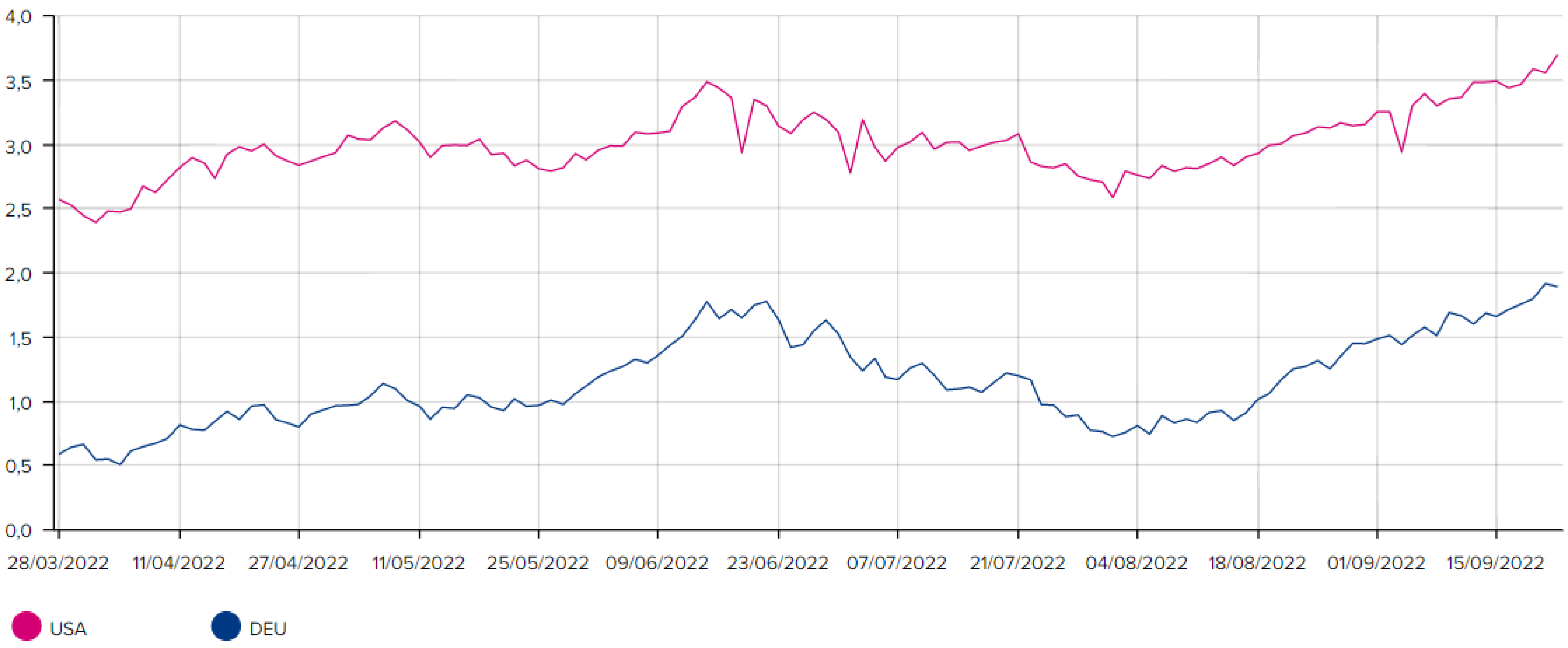
Belgium



Source : Statbel
https://statbel.fgov.be/fr/themes/prix-la-consommation/indice-des-prix-la-consommation

(5) Interest rates – Bye bye, “lower for longer”

10 year interest rates, US vs Germany – « pas de deux »



Source : Boursorama
https://www.boursorama.com/bourse/taux/

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(6) Social cohesion

Remember …

- *It is worth remembering that the chant going into Tahrir Square in the Arab Spring was "Bread, Freedom, Dignity."*

  (Jeremy Grantham, GMO, April 2022)

- *Public-opinion polls have shown that inflation (or something like inflation) has often been viewed as the most important national problem.*

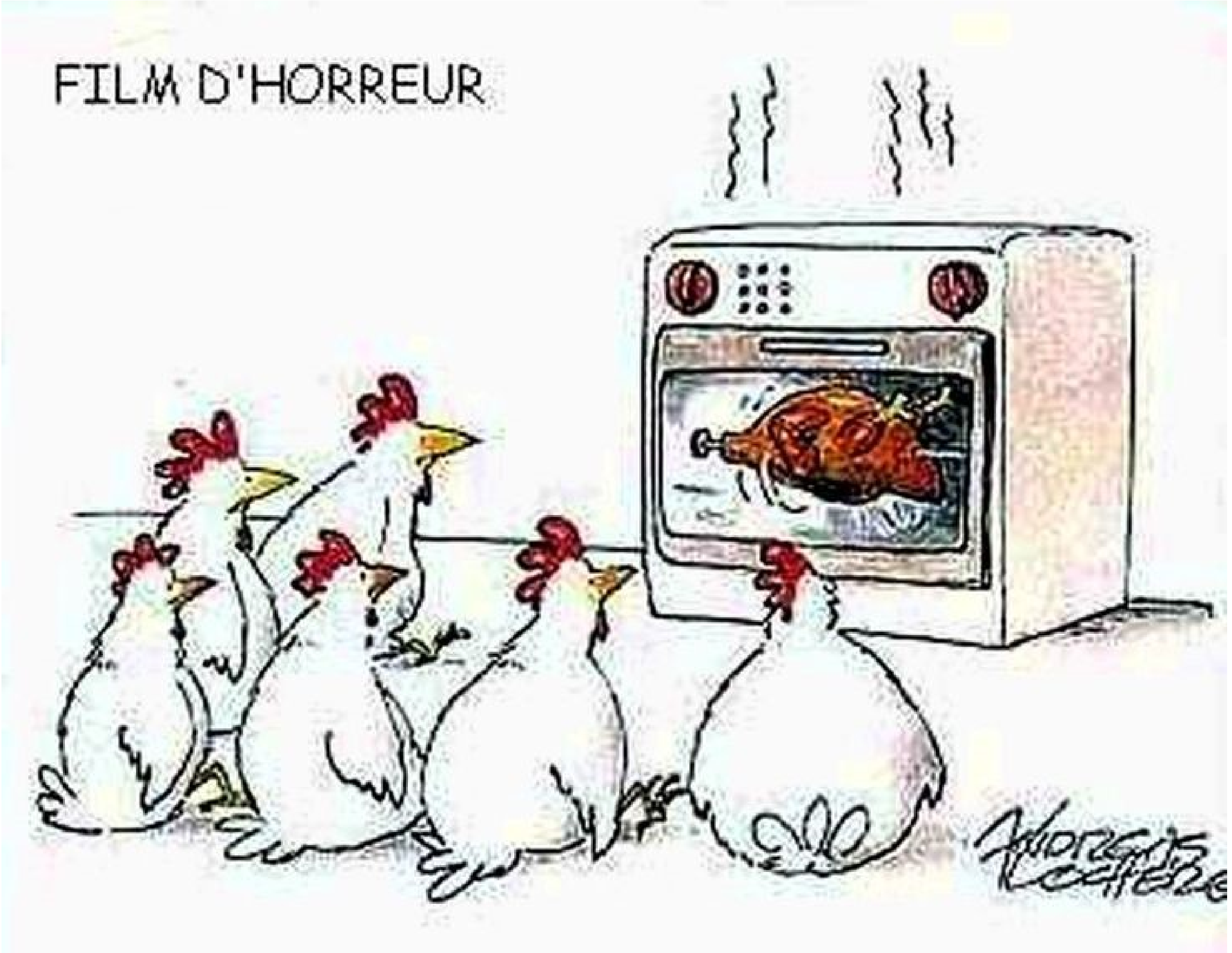
  (Robert Shiller (1997), quoted by Agarwal & Kimball, How Costly Is Inflation ?, IMF, March 20)

Run to shelter !

« The perfect storm »

- Public health
- Geopolitics
- Environment
- Inflation
- Financial conditions
- Social cohesion

BUT (a) we love horror shows



BUT (b) bad news are sometimes neither bad nor new

- Bad news that are not new
  - Russia (cf. Crimea)
  - China/Taiwan
  - Environmental concerns (Club of Rome 50 years ago !)

- Bad news no longer that bad
  - Covid
  - Worldwide food crisis due to missing grains from Ukraine

- Good news
  - Weakness of Russia
  - Democracies are not that inefficient (zero Covid policy in China …)
  - European integration (anti-fragmentation program)
  - Inflation Reduction Act in the US

BUT (c) crisis are the normality

Crisis ? What crisis ?

• 2008 – 2009	Great Financial crisis
• 2010 – 2012+	EU Sovereign debt crisis
• 2015 – 2016	Migration crisis
• 2020 – 2021	Sanitary crisis

Main lessons :

- “so far so good”
- Procrastination – to kick the can down the road

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2. Economic activity

Economic activity

12 months ago

Consumption
- Sustained income
- High savings
- No fear of unemployment

Capex
- Technology
- Climate transition
- ESG
- Low interest rates

Budgetary policy
- Low interest rates

Monetary policy
- friendly

Economic activity

12 months later

Consumption

- Sustained income **... BUT INFLATION**
- High savings
- No fear of unemployment **... BUT WAR**

Capex

- Technology
- Climate transition
- ESG
- Low interest rates

Budgetary policy

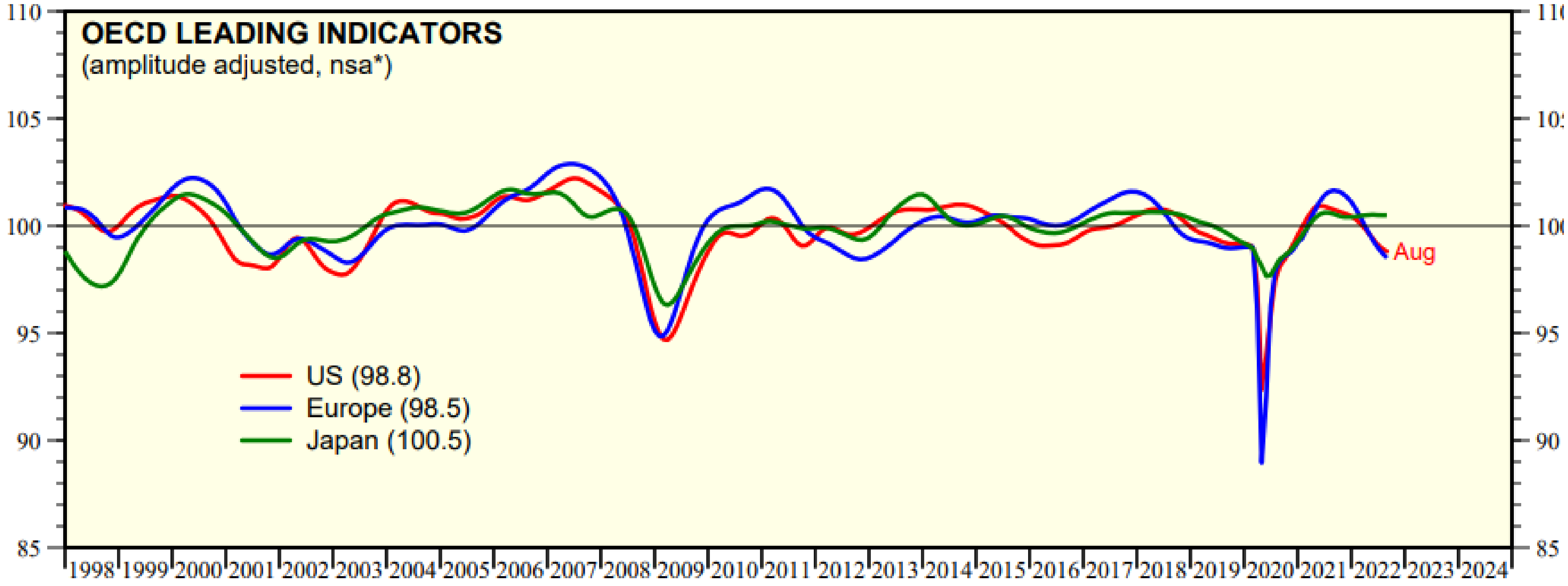
- Low interest rates
  ... BUT RISING

Monetary policy

- Friendly **... BUT LESS SO**

Economic activity

Sharp slowdown



Source : Yardeni Research, Global Economic Indicators
https://www.yardeni.com/pub/globalleadind.pdf

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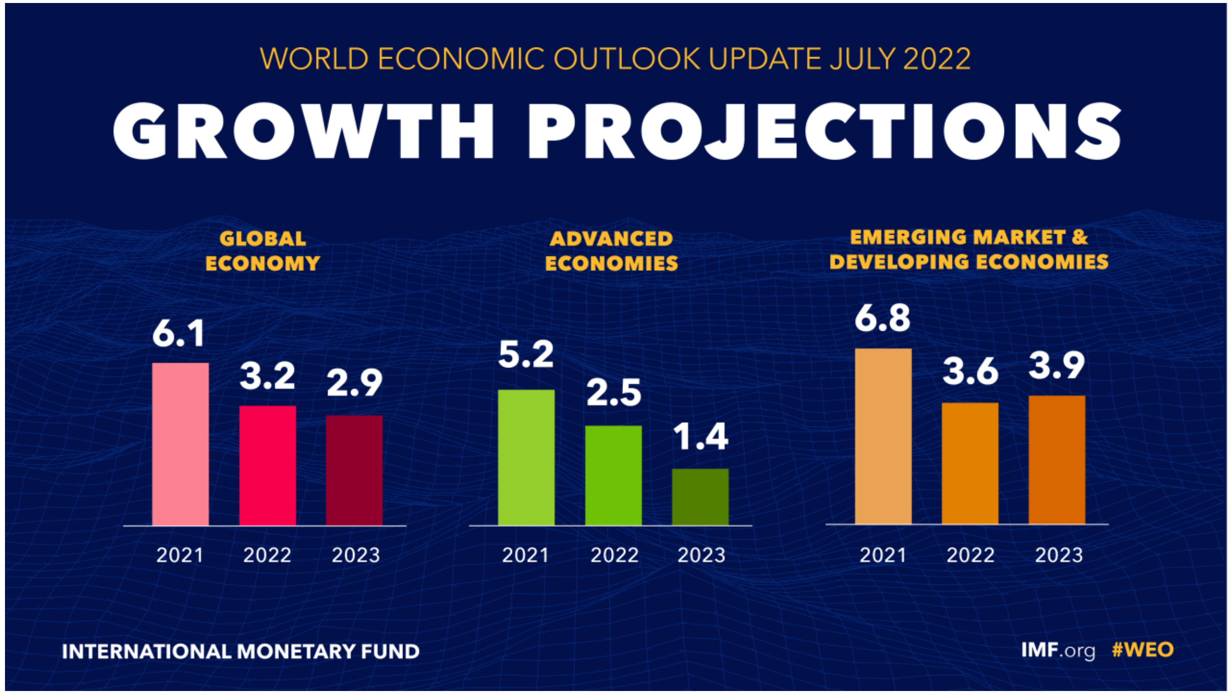
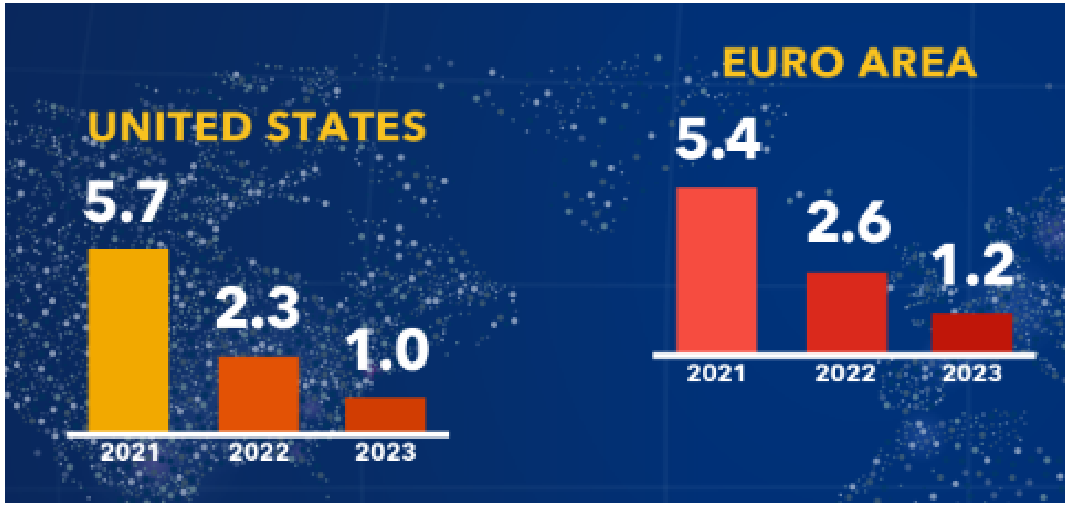
Economic activity

Sharp slowdown … but no deep recession





Source : IMF, July 2022

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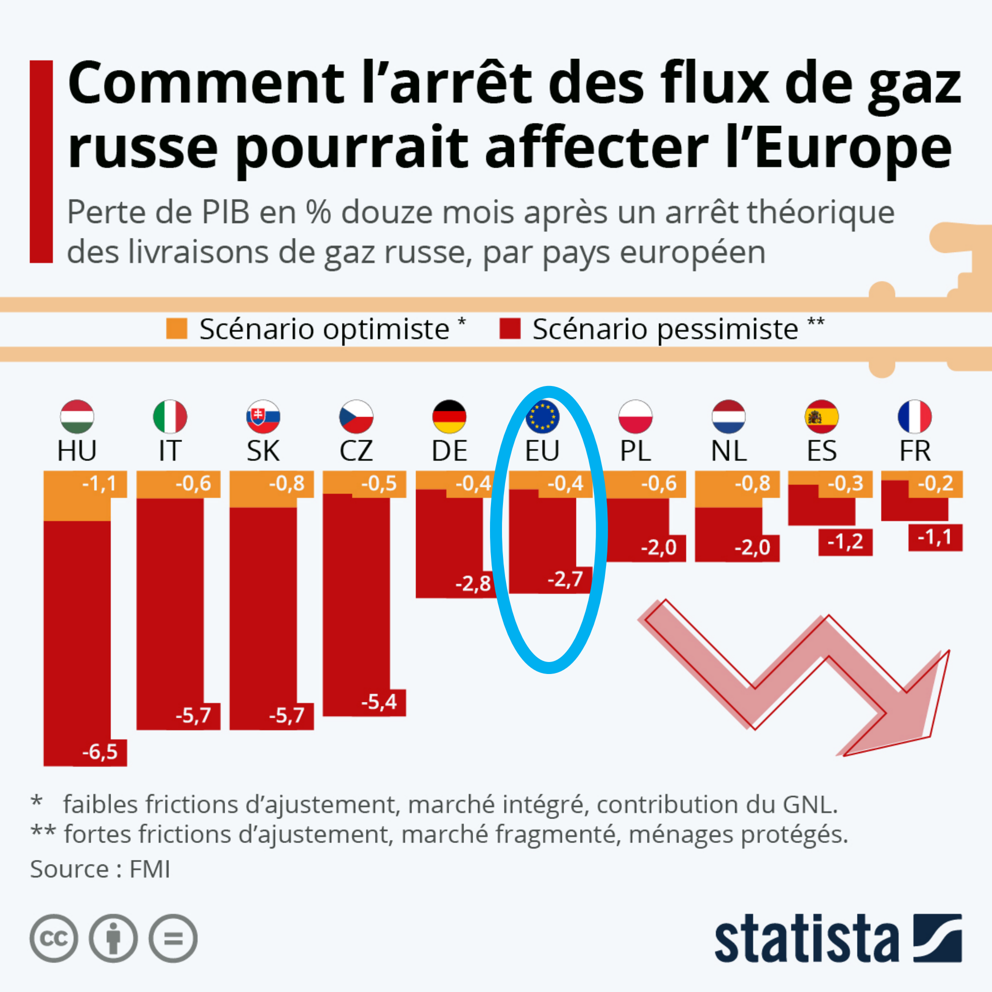
Economic activity

Ban on Russian gas : costly … but bearable



Source : Statista, 26 juillet 2022
Voir pour étude détaillée sur l'Allemagne, voir : https://www.econtribute.de/RePEc/ajk/ajkpbs/ECONtribute_PB_028_2022.pdf

Economic activity

Plenty of imminent threats

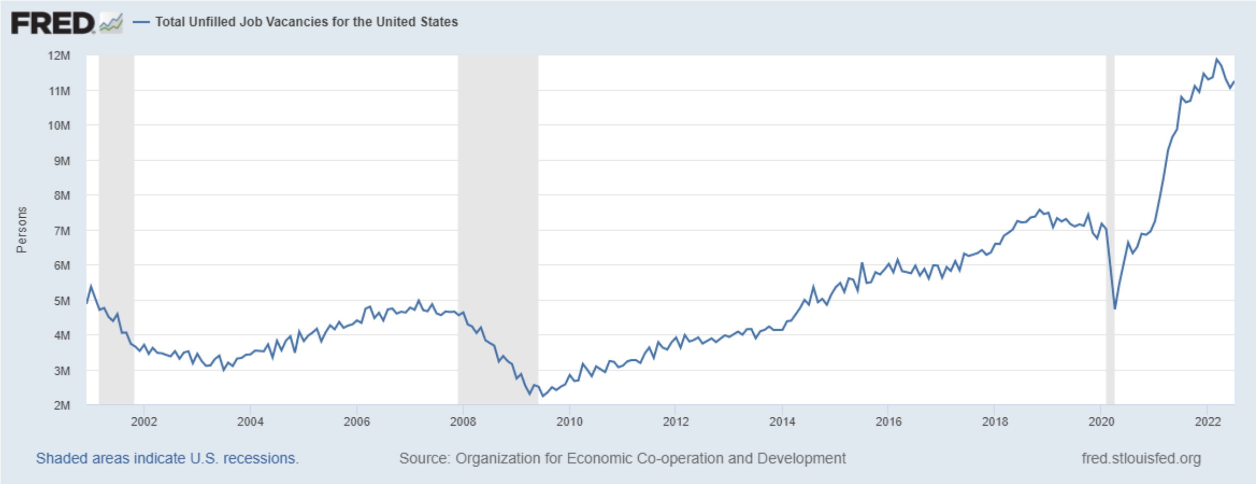
- War escalation
- Energy & power shortages
- Inflation => ↘purchasing power
- Uncertainty => ↘capital expenditure
- Monetary tightening
- Tension within the Euro Area
- Nationalism
- Negative wealth effect

© Crédits : Thinkstock / Femme Actuelle

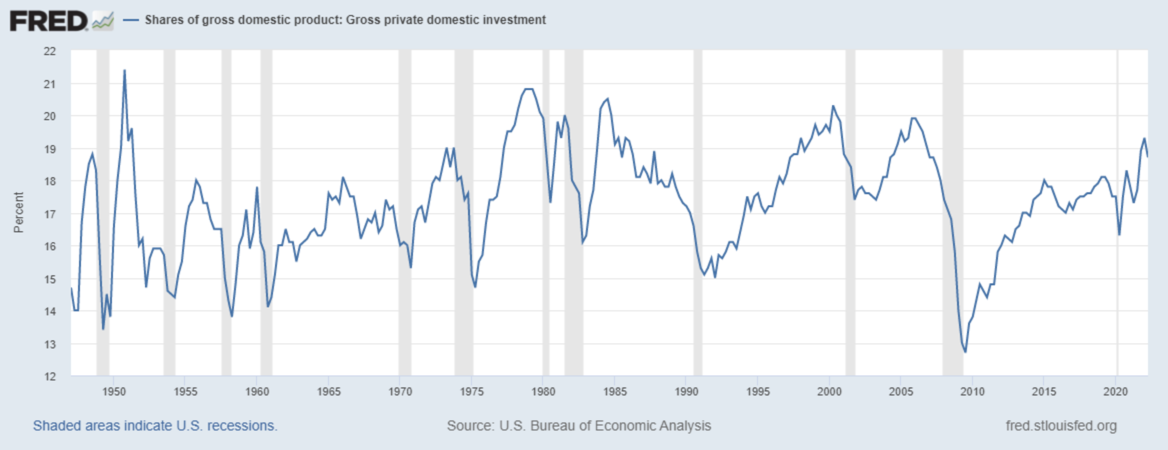
Economic activity

… but so far corporations do hire and do invest

United States



Source: Federal Reserve of Saint-Louis
https://fred.stlouisfed.org/series/LMJVTTUVUSM647S#



Source: Federal Reserve of Saint-Louis
https://fred.stlouisfed.org/series/A006RE1Q156NBEA#

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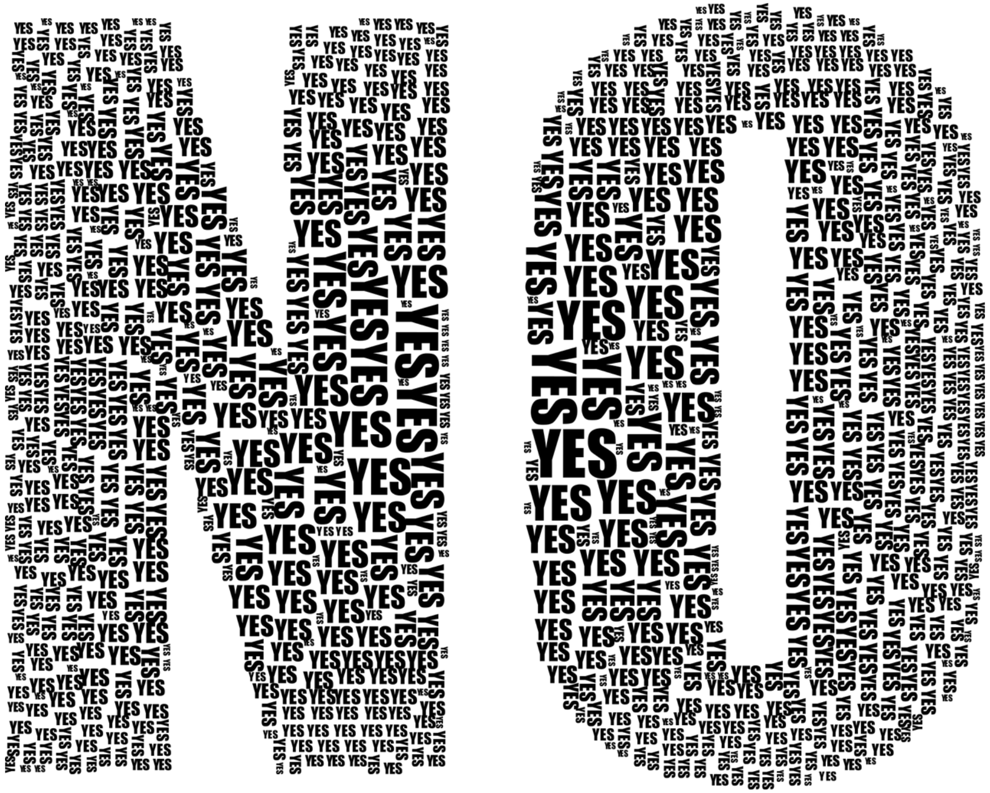
Economic activity

Bis repetita placent **– Yesterday's supports are still largely at play**

- Savings ratio
- Labor market
- Technology
- Environmental transition
- Lenient fiscal policy
- Low real interest rates

Economic activity



Sharp slowdown but NO deep recession

- Past support arguments (see previous slide)
- No negative surprise effect (cf. Jim O'Neill)
- Labor hoarding
- China will have to reignite growth

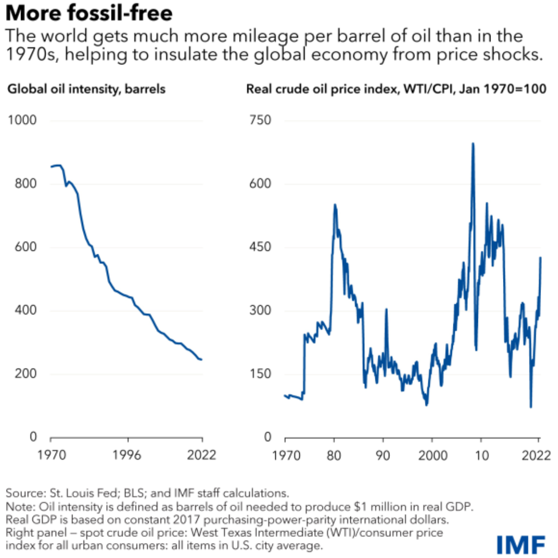
⇒ *My preferred "triple P" rule that a recession is a persistent (lasting in time), profound (in magnitude) and pervasive (across regions and sectors) contraction in economic activity is not currently satisfied.* (Greg Daco, 25 July 2022)

Economic activity

“Stagflation is back” ? Yes and mostly no

Mind the difference

• Lower growth + higher inflation	YES
• **Back to the 70s ?**	**NO**
* inflation then	much higher
* inflation anchoring then	absent
* growth then	much lower
* unemployment then	much higher and rising
* oil/GDP then	much higher
* wage indexation then	much more frequent
* trade unionization then	much stronger



Source : Nico Valckx, Lower Oil Reliance Insulates World From 1970s-Style Crude Shock, IMF Blog, May 2022

3. Inflation

Inflation

From one fear to another

Where is the deflation story gone ?
Do you remember ? Not so long ago what was the macro risk #1 ?
The "japanization", meaning a perma deflation world !

Inflation

Commodity prices – "Houston, we have a problem"

2003 – 2022, All Commodity Price Index, 2016 = 100

: All Commodity Price Index, 2016 = 100, includes both Fuel and Non-Fuel Price Indices

Source : IMF, IMF Data, Primary Commodity Price System
https://data.imf.org/?sk=471DDDF8-D8A7-499A-81BA-5B332C01F8B9&sId=1547558078595

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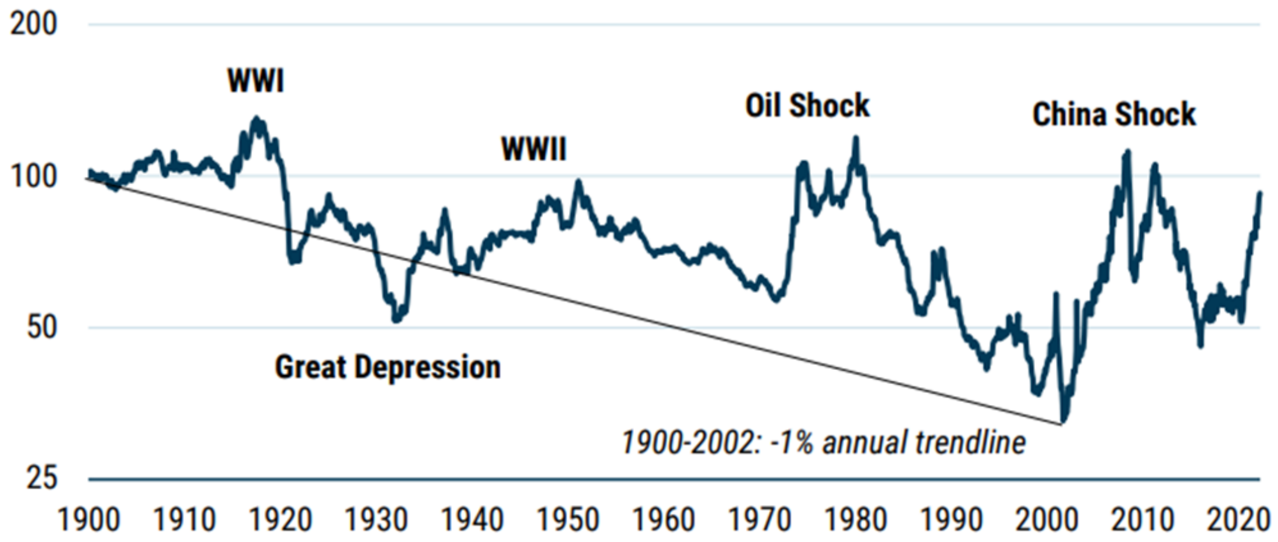
Inflation

Commodity prices – the end of a trend ?

EXHIBIT 2: GMO COMMODITY INDEX



As of 3/31/2022 | Source: Global Financial Data, GMO

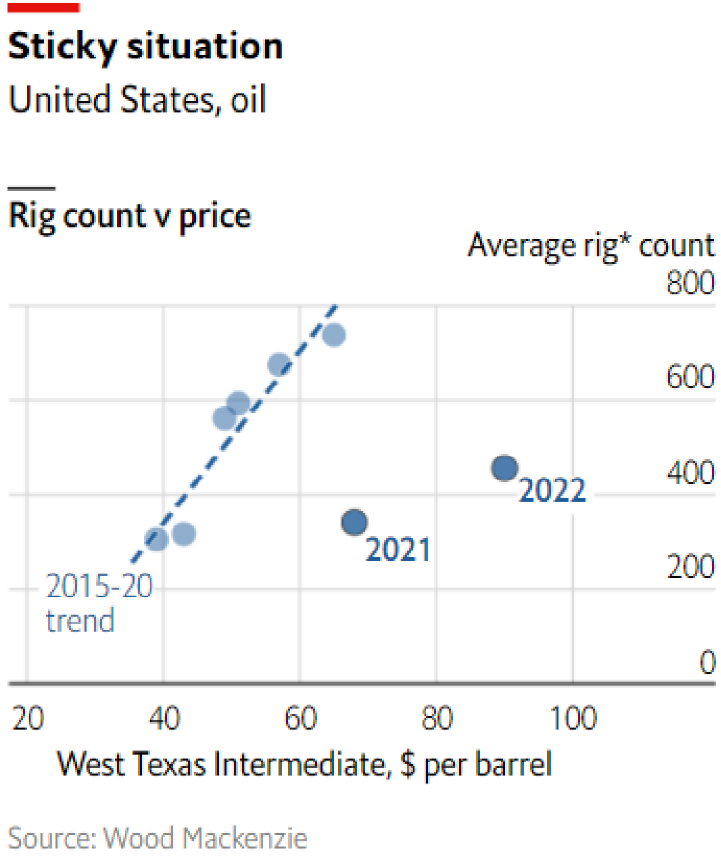
Source : Putin's Invasion Reminds Us That We Live In A Finite World, GMO, April 2022

Inflation

Commodity prices – why a reversal ?

- The environmental transition
  - New needs (transport, heating, …)
  - Regulation
  - Polluter pays tax principle
  - Fear of stranded assets => lowering of supply
  - Lower yields (impact of climate and of less polluting inputs on yields)
- Social concerns (labor conditions)
- Growing demand from emerging countries

…



Source : The Economist, March 28, 2022

Inflation

Inflation at large – why a reversal ?

- Russia
- Covid
- Exchange rate depreciation of the euro

AND ALSO

- Emerging markets no longer emerging / higher wages
- Re-shoring / friendly shoring / end of globalization
- Demographics + “*Great resignation*” = Labor shortage
- Mismatch supply vs. demand
  - on the labor market
  - on the goods and services market

+ Excessive money supply ???

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Inflation

A reversal ? Mind your mind !

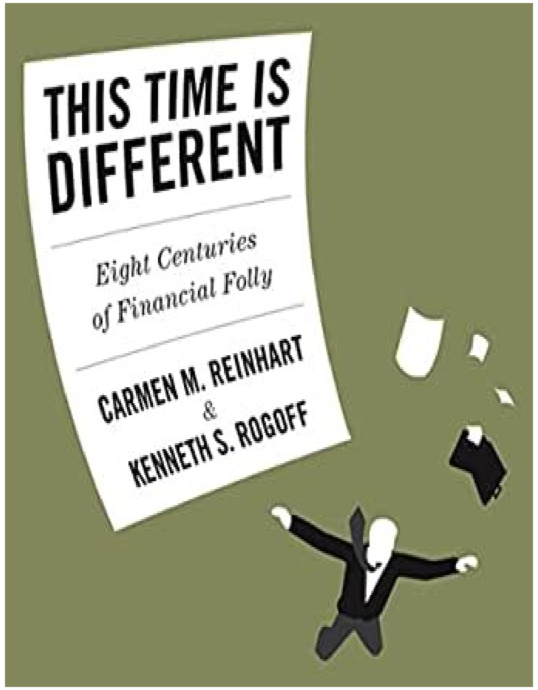
Be careful!

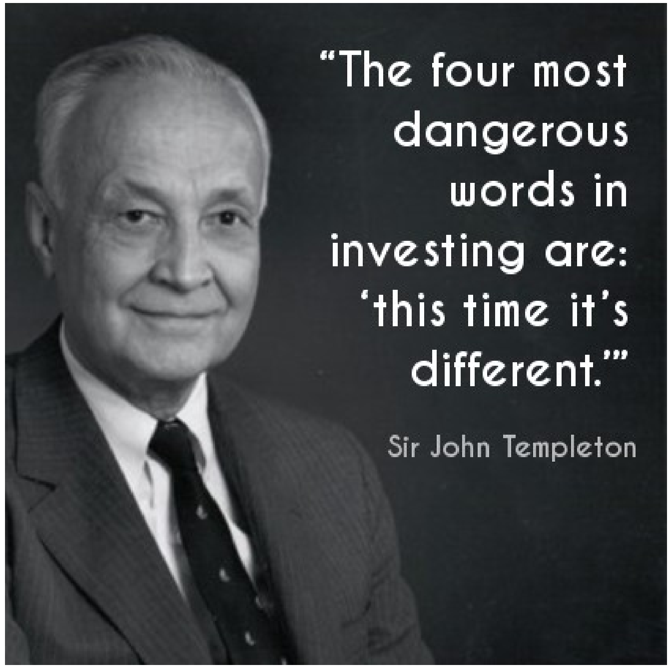
- *"This time is different"*? Unlikely, as times are rarely that different !!!
- Higher prices => Higher supply

  \+ Demand substitution

  \+ Innovation

  => self-correcting process



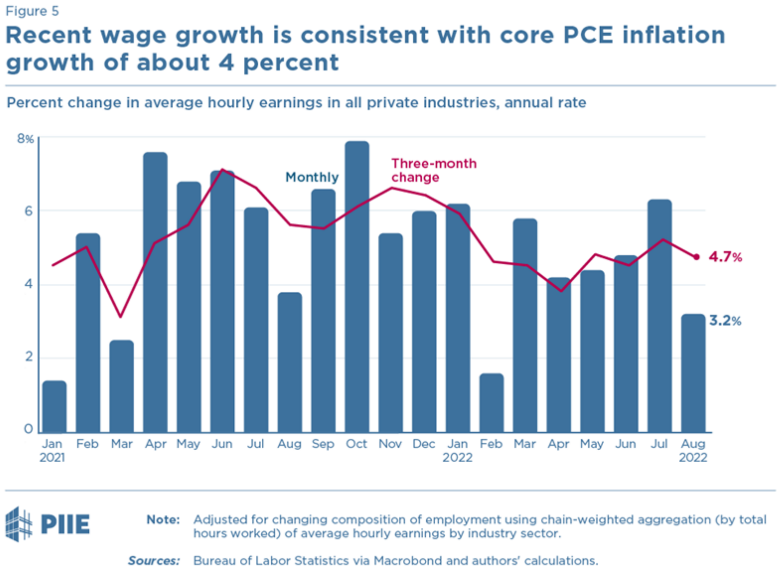


Inflation

Back to « business as usual » ?

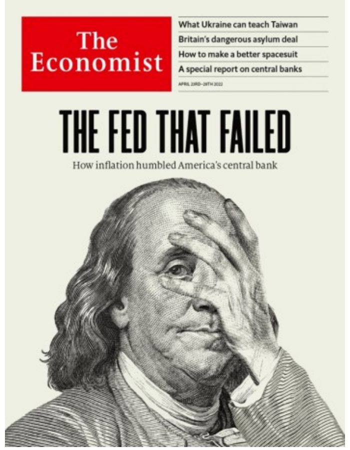
Arguments :

- Self-correcting mechanism : with ↗ price, ↗ supply AND ↘ demand
- Declining prices (oil, other commodities, freight, …)
- Bottlenecks are vanishing
- No wage-price spiral, at least at this stage (see graph)
- Competition from low wage countries far from being over
- Technology
  - Teleworking => increased competition between workers
  - Increased productivity
- Room for lower corporate margins (revival of competition rules ?)
- Commitment of central banks
- Credibility of central banks still intact (see next slide)



Source : Jason Furman (PIIE) and Wilson Powell III (Harvard Kennedy School), A tight US labor market stays tight, PIIE, September 2, 2022

Inflation

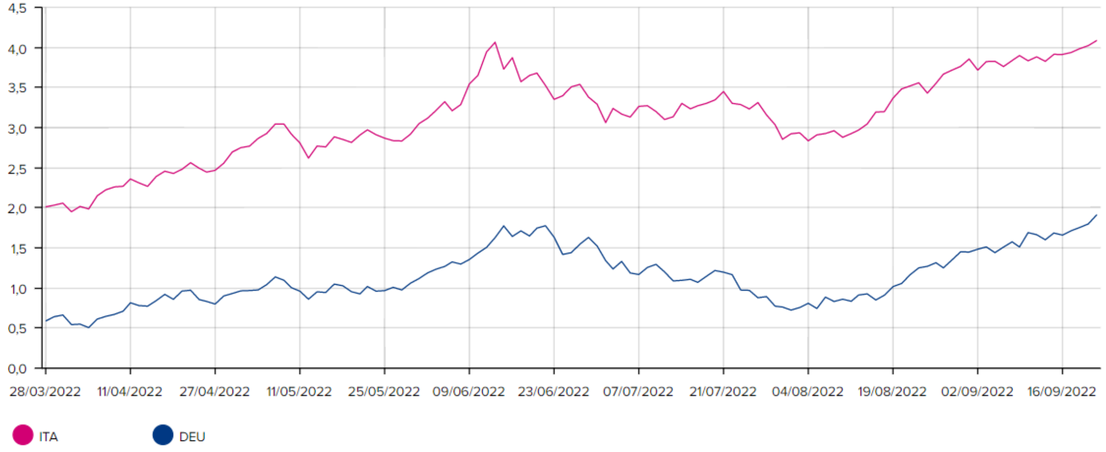


Central banks : poor record, strong credibility

- Mistakes : inflation, not announced, then seen as temporary

Federal Reserve Chair Jerome Powell admits 'we now understand better how little we understand about inflation'

Ecart de taux 10 ans, Allemagne/Italie



BUT

- Real rates still close to zero, or below 0%
- Limited spread widening
- Markets do follow central banks' guidance

⇒ *Don't fight the Fed*, more than never !

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Source : Boursorame
https://www.boursorama.com/bourse/taux/

Inflation

Markets do not expect a new inflation regime

United States

Source: Federal Reserve Bank of Cleveland calculations based on data from Blue Chip, Bloomberg, Bureau of Labor Statistics, Federal Reserve Bank of Philadelphia, Federal Reserve Board, Haver Analytics, and the model of Haubrich, Pennacchi, and Ritchken, 2012. "Inflation Expectations, Real Rates, and Risk Premia: Evidence from Inflation Swaps." Review of Financial Studies, 25(5).

Source : Federal Reserve Bank of Clrveland, updated Sept 13, 2022
https://www.clevelandfed.org/en/our-research/indicators-and-data/inflation-expectations.aspx

Inflation

Nevertheless, it's wise to protect portfolios against some structurally higher inflation

Arguments :

- Environment
  - Higher taxes, more cumbersome regulation
  - Switch in demand patterns, with asymmetric price effect
  - Lower crop yield, lower labor productivity
  - Higher insurance premia

- Increasing production costs
  - Demographics (see Goodhart & Pradhan, 2020)
  - De-globalization (nationalism, risk diversification, border tax adjustment, …)
  - End of wage compression

- Economic policy
  - Some higher inflation is desirable ! (see next slide)

Référence détaillée : C.A.E. Goodhart1 and Manoj Pradhan, The Great Demographic Reversal: Ageing Societies, Waning Inequality, and an Inflation Revival, SUERF, SUERF Policy Note, Issue No 197, October 2020
https://www.suerf.org/docx/f_fa99ccdbea597263a88f27075bd6eb49_17385_suerf.pdf

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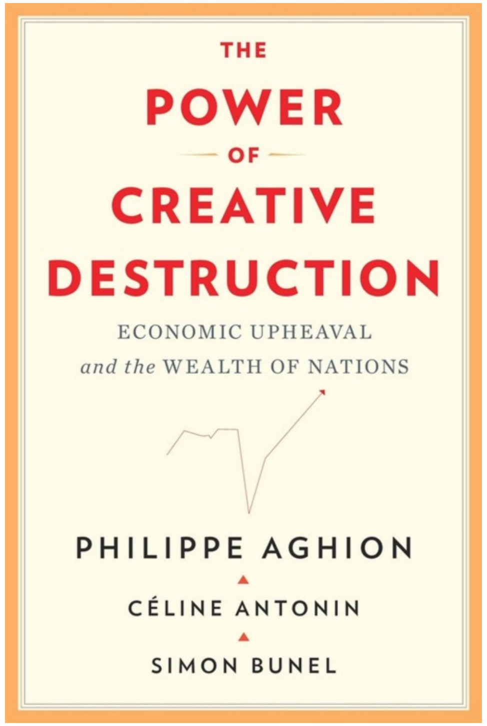
Inflation

Inflation, my friend … “Economists against the people” ?

- **Cons**
  - Losers and winners, with adverse social impact
  - Uncertainty => less activity / higher risk premium
- **Pros**
  - Good for indebted authorities … and therefore for macroeconomic & financial stability
  - Penalty on cautious savings => higher consumption and/or more risk-taking
  - Creative destruction; **reallocation of resources** (labor & demand for goods) ; higher productivity
  - Away from the « *zero lower bound* » limit / good for monetary policy
  - Push for anti-trust policies



“How I learnt to stop worrying about public debt and inflation”

Martin Sandbu, Financial Times, Sept 22, 2022

Further reading : Agarwal & Kimball, How Costly Is Inflation ? IMF, March 2022

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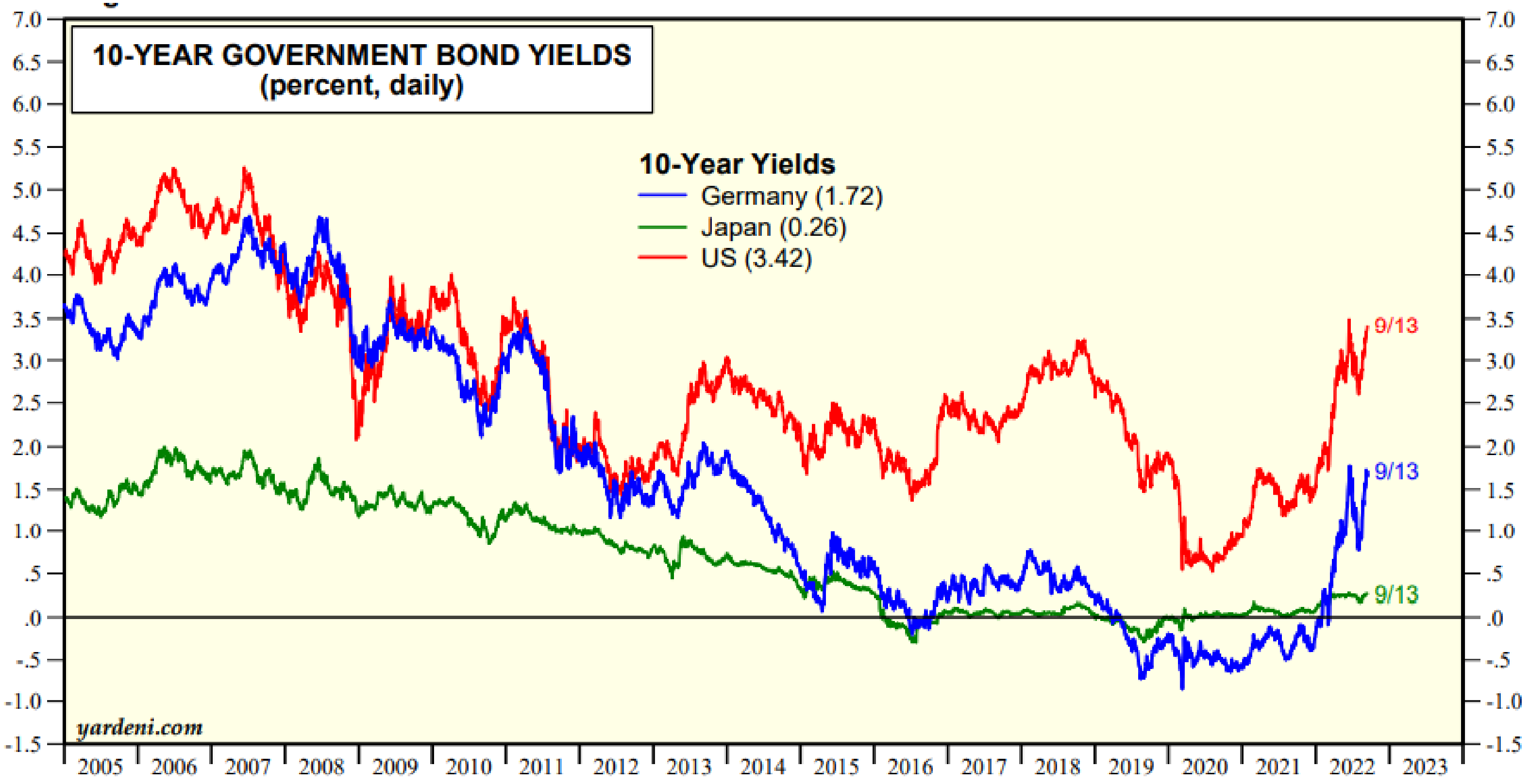
4. Interest rates

Interest rates

Higher, and rather rapidly higher … but from a definitely low starting point !



Source: Haver Analytics.

Source : Yardeni Research, Global Interest Rates
https://www.yardeni.com/pub/glir.pdf

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Interest rates

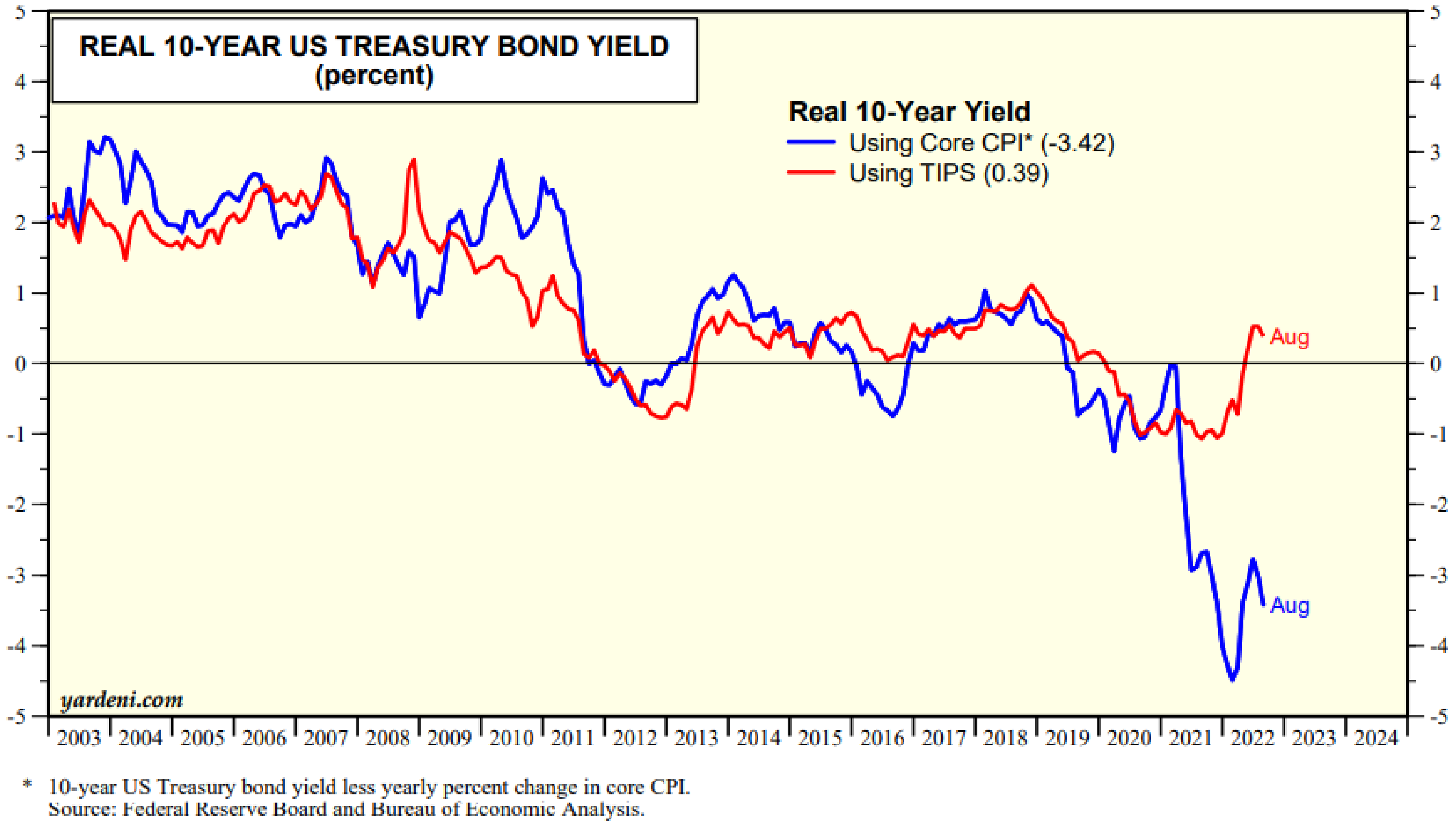
Rates – much higher or not ?

YES as far as NOMINAL rates are concerned, definitely less so for REAL rates

	YEAR START	NOW	
(a) Nominal rate	**0%**	**2,5%**	**YES, MUCH HIGHER**
(b) Inflation			
– 2022	2%	9,4%	
– 2023	2%	6,5%	
– 2024 until 2031	2%	2,5%	
– Average over 10 years	**2%**	**3,6%**	
(c) Real rate [=(a)-(b)]	**-2%**	**-1,1%**	**NOT REALLY**

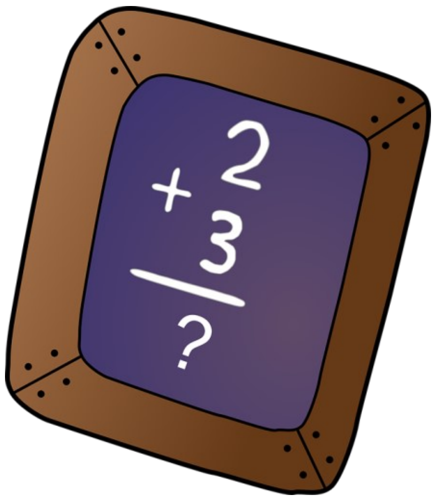
Interest rates

Real interest rates are still low (US), or even negative (Germany)



Source : Yardeni Research, Global Interest Rates
https://www.yardeni.com/pub/nomrealyield.pdf

Interest rates



Savings account, the surest way to lose some purchasing power

	« Before »	2023
Nominal return :	+ 0,11%	+ 0,50% (???)
Inflation :	+ 2,00%	+ 6,50% (Bureau du Plan)
Real return :	**- 1,89%**	**- 6,00%**

Bureau fédéral du Plan

Budget économique

Institut des comptes nationaux

8 septembre 2022

Chiffres clés pour l'économie belge

Pourcentages de variation en volume sauf indication contraire

	2020	2021	2022	2023
Indice national des prix à la consommation	0,7	2,4	9,4	6,5
Indice santé	1,0	2,0	9,1	7,0

Interest rates

Interest rates : summit in sight … pending the Russian roulette

- Inflation has peaked (base effect + no wage / price spiral) assuming no further war escalation
- Recession will be there to prevent zealous tightening
- Inflation rate expectations remain well anchored
- *"Necessity knows no law"* (*"nécessité fait loi"* / *"nood breekt wet"*)
  - States : heavily indebted
    + ageing
    + social discontent
    + financing of the transition (regulations & taxes are way too unpopular)
  - financial stability requirement (within the Euro Area; financial sector as creditor)

+ Higher rates not efficient to fight against supply-driven inflation (see next slide)

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Interest rates

Higher rates, unfitted to fight against supply-driven inflation

- Higher rates against demand-driven inflation, YES
- … but in Europe to a large extent inflation is supply-driven
  - Energy shortages
  - Labor supply shortages
  - Changes in consumption patterns / mismatches
  - Environmental transition

⇒ Tools to be considered

- LOWER rates in order to boost capex (to ↗productivity, to finance transition capex, and to offset declining labor supply) …
- Active labor market policies
- Competition rules, against « *pricing power* »
- State regulation (price setting for some sectors, like energy, …)

Interest rates

Interest rates : no “Volcker moment”

- No need

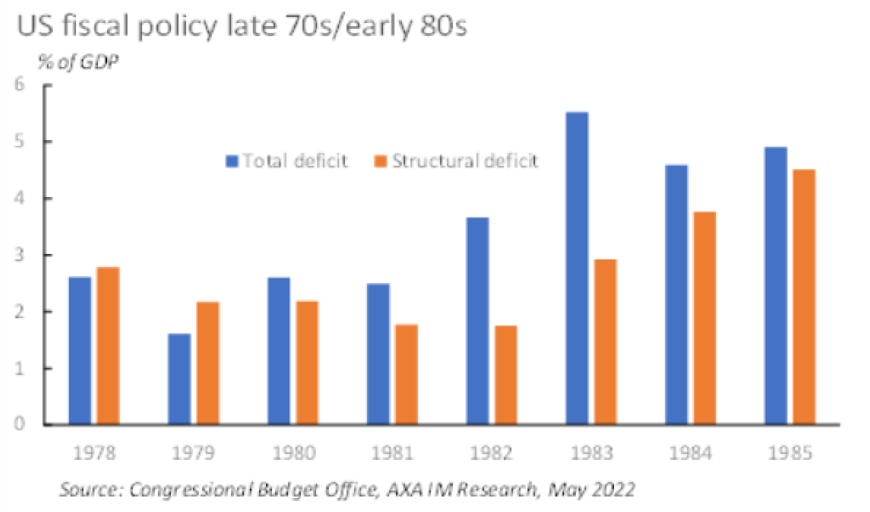
  (anchoring of expectations, no wage spiral, …)

- No possibility

  in 1983, US economy salvaged by fiscal expansion …

  today, public indebtedness is much higher

Exhibit 4 – Fiscal policy “picked up the pieces” 3 years later



Source : Gilles Moec, « Volcker- Skelter », Axa IM, # 137 – 30 May 2022

Interest rates

No paranoid belief : the central bank is my friend !

The Central Bank is my friend, not a dogmatic Moloch in a ivory tower requiring human sacrifices !

How the S&P 500 performs in Fed rate-hike cycles

■ Average annualized return

Source: Truist Advisory Services

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Conclusion

Conclusion

To sum up

- Uncertainty, yes but *“as usual”*
- A recession, most likely, but no deep recession on the agenda
- No wage/price spiral, and inflation to slow down (pending no further geopolitical escalation)
- Real interest rates to remain subdued

Warning

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Past performance is not indicative of future results.

The primary risk of investing is a loss of capital that may be permanent and that may be complete.

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