

After the real shocks of the pandemic and the war in Ukraine comes the Powell/Volcker shock / Banks and the economy in difficulties

The high inflation rates of the last two years have convinced many – especially Jerome Powell, chair of the Fed – that only monetary shock therapy can prevent the development of a wage-price spiral, something which would cause inflation expectations to come unmoored over the long term. His exemplar in this is the policy of Paul Volcker, who brought a decade of rising inflation to a decisive end at the start of the eighties by means of a sharp recession. Many commentators and analysts, who for years have criticised the expansive monetary policy of central banks, share this assessment and support this brutal process. Other prominent economists and analysts have expressly warned, however, of comparing the current situation with the post-war one. They have stated their conviction that the wage formation process has, in the last 40 years, largely been decentralised and delegated to the corporate or even the individual level, with collective bargaining widely losing importance in the private sector. The risk of a wage-price spiral must thus, they assert, be considered low. Investors in capital markets shared this assessment from the very beginning: long-term bond yields have continued to lie far below current inflation rates. Despite these factual circumstances, Powell has opted for shock therapy, also roping the heads of other central banks into the policy last year in Jackson Hole. Now we have to deal with the consequences of this shock: namely, a new banking crisis and a further slump in global growth. Let us take a closer look at these facts.

The graph below shows that Powell has triggered a monetary shock of unparalleled proportions in history.

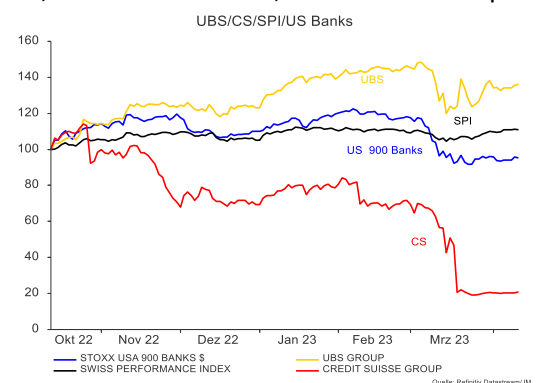
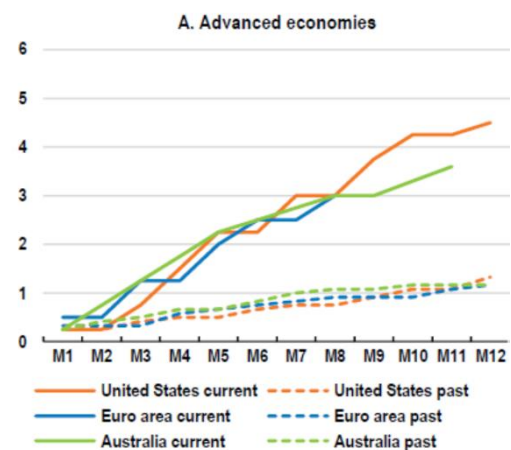
The graph shows the current monthly rise in interest rates for three central banks (USA, Europe and Australia) starting from the first rate hike, compared with the average increases from previous cycles of interest rate rises. In the historic average, rates were raised by a total of 1.25% over twelve months. The current hikes are around four times greater.

This rapidity has left banks little time to adjust their balance sheet structures. During the pandemic, they registered extremely high inputs into savings, which they could not invest by granting credit. Many placed the excess funds into less risky bonds. With fatal consequences: the rapid interest rate rise has heavily devalued bonds and thus reduced the banks' capital. It doesn't help that American banks are allowed to account for bonds – if held until maturity – at their nominal values. The stock market, for its part, does consider the unrealised loss. For this reason, all bank stocks – depending on the balance sheet structure – have more or less lost value. The loss in market capitalisation has, in individual cases, led to bank collapse. Silicon Valley Bank, for example, lost the confidence of its customers. They withdrew funds and the management was forced to sell bonds. Unrealised losses became realised ones. Equity capital had to be written off. The bank run took its course. In its latest stability report, the IMF indicates that it is particularly the regional banks that have significant unrealised losses on their books. This has negative effects on further credit activity. The banks are less able to cover losses. They have significantly increased their credit-granting requirements. The IMF is working on the basis of a marked reduction in investment activity over the next two years.

These impediments to financing have very restrictive effects on economic activity. The central banks will have to reflect this with less violent interest rate hikes. For this reason, market participants have rightly reduced expectations for central banks' interest rates by around 40 base points. The long-term rates have also dropped by around half a percentage point as a consequence of the banking crisis.



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The restrictive monetary policy will only show its effects on the real economy and inflation in the coming 12 to 18 months. The experience of history shows that the delay on central bank policies having an effect is between one-and-a-half and three years. In the next two years, therefore, the global economy is likely to weaken significantly. The consensus estimates for growth in the G7 states are 0.8% (2023) and 1.2% (2024). This represents around half of what would be required for the full exploitation of capacity. We must therefore reckon with profit reductions, layoffs, increases in defaults and further banking problems.

In addition, energy bottlenecks will have to be dealt with again next winter if the weather is harsher than this year. The aggravation of the geopolitical situation could also lead to limitations on global trade.

Against these risks, however, arise significant opportunities. There is a high chance that the central banks' bleak wage-price scenario will not come into being, and that they will have to quietly abandon their aggressive restrictive policies. Who could blame them in such a situation for taking credit for the lower inflation rates? Even if this will scarcely be the case before next year, the capital markets will already incorporate such a result in long-term rates this year. A further drop in G7 long-term rates is thus already possible in the second half of the year. Then, the interest rate upturn heralded by so many could finally be a thing of the past. The hope that this would make saving worthwhile again will also hardly come to pass. It can be foreseen that the forces in effect for the last thirty years, driving the real interest rate ever closer to zero, will rise again with renewed vigour. This is a promising outlook for most capital investments.

It could well be that the favourable medium-term prospects are able to calm the waves made by the monetary shock. This expectation and relatively favourable valuation levels in many cases make it seem sensible to remain fully invested in stocks, accepting any short-term setbacks. Our confident inflation and interest rate forecast justifies our slightly overweighted bond position.

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

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